Sunnier Days For The Global Economy

The global economy is projected to register its best performance since 2014 this year. Though geopolitical risks abound, recent economic data point to strengthening growth prospects in most areas of the world (Charts 1 and 2). This has translated into higher equity valuations in many countries, a re-evaluation of the likely interest rate path in the United States and yield curves globally, and significant increases in both household and business confidence. From a purely economic perspective, the risks might actually be characterized as unbalanced toward the positive, for the first time in many years, given the momentum already underpinning global growth. Risks, however, remain very important. The Trump Administration's approach to trade policy, which has not yet been fully articulated, represents a significant risk to the global recovery. Other geopolitical risks include the electoral cycle in Europe and the potential for sustained capital outflows in China. All this implies that while it may appear that we are entering a stronger, more sustained phase of the global recovery, it is too early to put on our Ray-Bans.

The United States appears to be set for a solid economic performance this year, with growth rising to 2.3% from the 1.6% achieved in 2016 (Table 1). This is well above our estimate of trend growth of roughly 1.7%. Growth in most sectors of the economy appears to be accelerating. Most importantly, there is evidence that business investment is on the rise, as indicators of both business confidence and activity, and orders for capital goods, point to a modest rebound in capital spending in the United States. Continued job gains, the acceleration in wage growth and rising consumer confidence will contribute to another record year for auto sales, and should provide healthy support to the housing market. With growth exceeding trend, and wage inflation accelerating, inflation should be close to the Federal Reserve's implicit 2% target in 2017. Building price pressure will require significant monetary tightening, and we forecast three 25 basis point increases in the Federal Funds target rate by end 2017. Higher interest rates in the United States, which are not yet fully priced by markets, and improved growth prospects, should lead to a generally stronger US dollar against most major currencies. The rise in the US dollar, and the strength in domestic demand, should lead to a pick-up in imports, which should lead to deterioration in the trade balance, potentially inflaming protectionist rhetoric.

Our US forecast reflects only a modest gain from President-elect Trump's policies at this point, in contrast to the sharply positive view now reflected in asset prices. Our judgment, at this time, is that the President-elect's fiscal policies will be mildly stimulative over the forecast period. Moreover, any potential increase in growth and prices associated with the policies of the new administration might require tighter monetary policy, thereby limiting their impact. Any measures explicitly designed to discourage imports will be damaging to the United States and its trading partners. This is a key, presently unquantifiable, negative risk to the forecast. Were significant trade actions to take place, the resulting increase in the price of imported and domestically produced goods could lead to even higher interest rates in the United States, even as growth slows.

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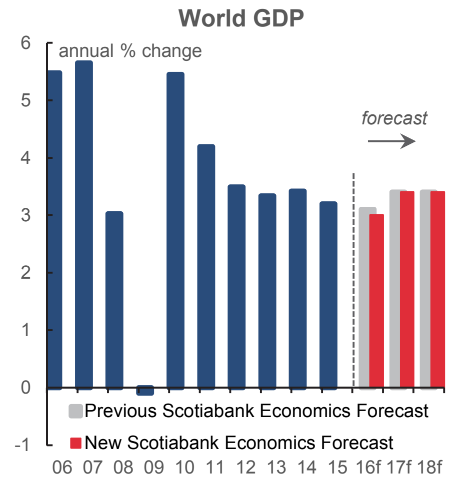
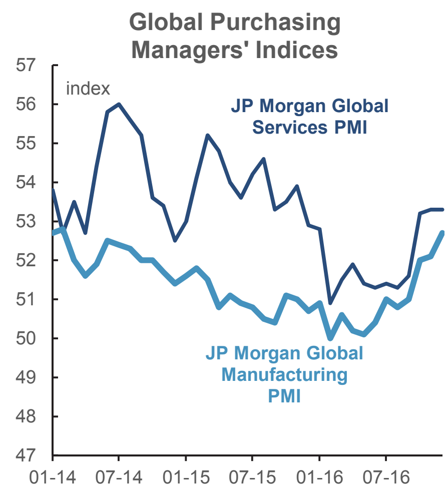
Chart 1



Sources: Scotiabank Economics, IMF.

Chart 2



Sources: Markit. Bloomberg.

Canadian growth will accelerate to 2.0% in 2017 from 1.4% in 2016 as the economy benefits from stronger US growth, an increase in oil prices, a weaker currency against the US dollar, and public infrastructure programs. Adding to these factors, and perhaps because of them, businesses appear cautiously confident in their prospects, with firms expanding their hiring while tentatively considering increased investment. We forecast that exports will rise more than twice as fast in 2017 as they did in 2016 as both resource and non-resource exports respond to rising US business activity, the weaker Canadian dollar against the greenback, and higher oil prices.

While our forecast for 2017 is substantially above our trend growth estimate of 1.5%, it incorporates fiscal policies that add about 0.5 percentage points to growth. Absent this boost, growth would be at trend, and just above last year's level. Two key factors underlie our projection. First, we expect the housing market to cool modestly in 2017 given deteriorating affordability, last year's Federal measures to cool the housing market, and the rise in mortgage rates observed to date. Housing starts should fall to roughly 190,000 units from the nearly 200,000 units pace set in 2016. As a consequence, residential investment should exert a small drag on growth in 2017, following a modest positive contribution in 2016. Second, auto sales should slow after four consecutive annual records. Given that, there is less replacement demand in Canada than in the United States, which had weak sales for an extended period and only recently returned to a strong sales pace. Owing to the slack remaining in the Canadian economy, inflation should converge to the Bank of Canada's target on a sustained basis in mid-2018. The resulting interest rate differential with US interest rates should lead to a weakening Canadian dollar through the first half of 2017, followed by a period of gradual appreciation as higher oil prices once again become the dominant driver of the loonie.

Though political uncertainty will remain high in **Europe** throughout this year's electoral cycle owing to strengthening support for nationalist/populist movements, data suggest an acceleration in growth in continental European countries. As in the United States and Canada, household and business confidence is rising. Furthermore, retail sales are strong, exports appear to be responding to stronger global demand and the weaker euro, and monetary policy continues to be highly stimulative. We forecast Eurozone growth of 1.7% in 2017, roughly in line with that achieved last year and well above trend growth. Given that core inflation remains low and is expected to remain well beneath the 2% level through 2018, we think the ECB will be in wait-and-see mode for the foreseeable future. It will become less dovish only when signs of economic expansion become more entrenched.

In the **UK**, growth in 2017 will moderate from last year's torrid pace, but still remain reasonably strong, at 1.6%. The key risk and challenge remains the Brexit negotiations and their impact on economic activity. For the time being, the large depreciation of the pound last year is providing a substantial boost to growth at the expense of rising inflationary expectations. While the feared negative impacts from the 'Leave' vote have yet to be seen in the growth numbers, we remain of the view that Brexit will impose some costs as the negotiations get under way and are eventually finalized. This could take a few years. In the meantime, there may be speculation of a more hawkish Bank of England as growth and inflation are expected to remain strong in the first half of the year. This should be unwound if our forecast of no growth in the second half of 2017 materializes.

The outlook for systemically relevant **emerging market economies** continues to improve, by and large, though capital flow volatility will remain a challenge as markets adapt to the higher US interest rate environment and potential capital repatriation in Mexico and other emerging market countries, and capital outflows in China. Growth in China appears to have rebounded solidly in the second half of 2016, and this momentum is expected to continue into 2017. Yet this positive development does not offset the loss of almost US$1 trillion in international reserves over the past two years. India will remain the fastest growing economy among those we track, though the demonetization program has dampened activity.

In the **Pacific Alliance** countries, growth in Colombia and Chile is projected to pick up from 2016. Adding to the positive effects of stronger global growth and higher commodity prices (particularly the case in Peru and Chile), increased investment is anticipated following the peace agreement in Colombia, and infrastructure plans and a more pro-growth approach in Peru (this country remains the top-performing economy of the four-member alliance). In Mexico, a modest slowdown is expected to materialize owing to a combination of factors: fiscal consolidation as the government moves aggressively to improve its fiscal position, higher interest rates stemming from the weaker currency, and a slower pace of investment given uncertainties related to President-elect Trump's potential policy actions.

Table 1 — Global Real GDP

	2000–15	2016e	2017f	2018f
		(annual % change)		
World (PPP)	3.9	3.0	3.4	3.4
Canada	2.2	1.4	2.0	2.0
United States	1.9	1.6	2.3	2.4
Mexico	2.4	2.1	1.5	2.1
United Kingdom	1.8	2.1	1.6	1.2
Euro zone	1.2	1.6	1.7	1.7
Germany	1.2	1.7	1.8	1.7
France	1.3	1.2	1.4	1.6
Russia	4.6	-0.6	1.2	1.4
China	9.8	6.7	6.4	6.0
India	7.0	6.8	7.5	7.8
Japan	0.9	0.9	0.7	0.6
South Korea	4.4	2.7	2.5	2.6
Indonesia	5.6	5.0	5.3	5.5
Australia	3.0	2.4	2.4	2.6
Thailand	4.1	3.2	3.2	3.1
Brazil	3.4	-3.5	0.5	2.0
Colombia	4.2	1.9	2.4	3.3
Peru	5.3	3.8	3.8	4.2
Chile	4.3	1.5	2.0	2.5

Canada

- **Growth is expected to accelerate over the next two years owing to firmer domestic activity, expanding fiscal stimulus, and increasing foreign demand.**
- **For the first time in years, housing and auto sales are expected, however, to provide a mild drag on growth.**

CANADA CONSOLIDATES GAINS IN 2017

Canadian economic performance appears to have been mixed in the second half of 2016, but activity looks set to strengthen during 2017. Underlying output growth averaged around 1.5% y/y during 2016 amid weakness in exports and business investment. Growth is expected to accelerate beyond the economy's 1.5% potential to around 2% during 2017–18 (Chart 1), supported by steady consumer demand, stabilizing investment, strengthening US domestic purchases of Canadian exports in the context of a weaker Canadian dollar (CAD), firmer oil prices, and fiscal stimulus, including increased Canadian infrastructure spending. Some moderation in major housing markets is, however, likely to provide a slight drag on growth.

STEADY CONSUMERS

Consumers remain relatively upbeat despite a mixed employment and tax picture for households: consumer confidence returned to its long-run average in December (Chart 2), though some survey data indicate major purchase plans have softened somewhat in recent months. New vehicle sales, for instance, are likely to come down after four consecutive record years, following recent price hikes. Domestic wage and income gains were held back throughout most of 2016 given the largely part-time nature of job creation. While there was a strong increase in full-time hiring at the end of the year, Canada's aggregate employment-to-population ratio is still around 2 percentage points below its pre-recession peak (Chart 3) and long-term unemployment remains high (Chart 4).

Apart from Quebec's elimination of its health contribution as of 2017, Canadian households are unlikely to witness material tax relief through 2018 as a range of levies are set to be raised. As of January 2017, Alberta and Ontario will join British Columbia and Quebec with broad frameworks for pricing carbon, followed by at least four other provinces a year later. The impact of carbon pricing will be softened for low-income households by credits offered by a number of provinces, which add to the 2016 enhancements to targeted federal and provincial benefits, notably Ottawa's and Alberta's respective increased child benefits.

Overall, we expect real consumer spending will grow in line with underlying real income growth of around 1.5–2% annually during 2017–18. The boost to household purchasing power and discretionary spending from the Canada Child Benefit should be partially offset by higher food and energy inflation, municipal fee increases, and higher mortgage costs. Record indebtedness amid rising interest rates shall likely limit the capacity of households to ramp up spending notably, and should prompt a more cautious approach to further debt accumulation.

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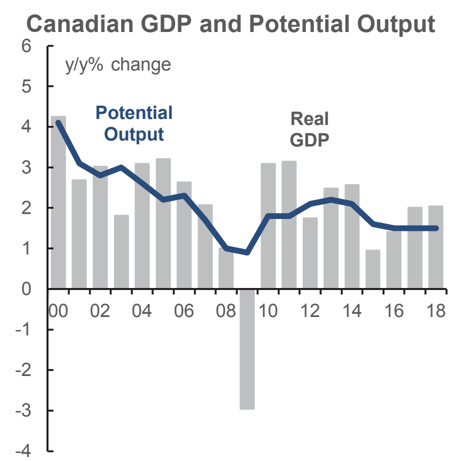
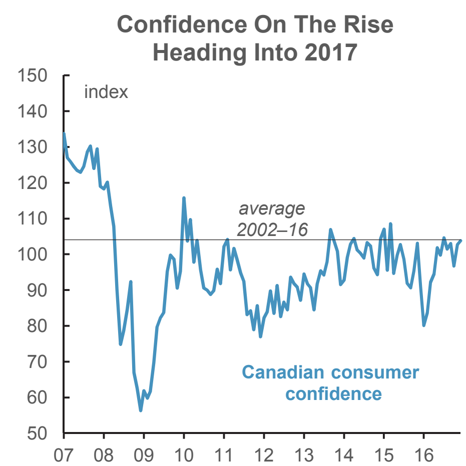
Chart 1



Sources: Scotiabank Economics, Statistics Canada, Bank of Canada.

Chart 2



Sources: Scotiabank Economics, Conference Board Of Canada.

HOUSING: LESS HOT

Although residential investment continues to account for a near-record share of Canadian economic activity (Chart 5), a less torrid housing market in Toronto and Vancouver, combined with a calmer situation in the rest of the country and a modest decline in housing starts, should bring residential investment down slightly during 2017. National home sales are forecast to decline about 5% in 2017 given the significant erosion in affordability in several of Canada's large urban centres, and the impact of both the latest tightening in mortgage insurance rules and the additional transfer tax on foreign real estate investors in Metro Vancouver. Home prices are, however, expected to continue rising, albeit at a slower pace, owing to historically tight resale supply.

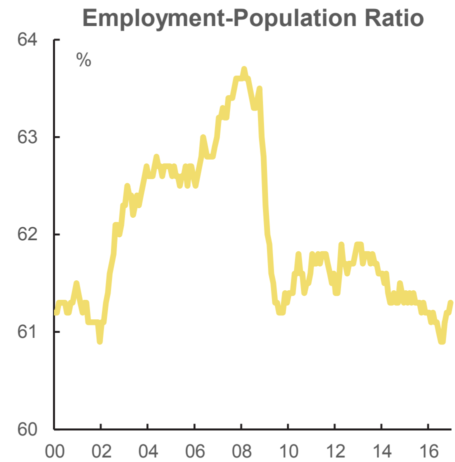
The recent uptick in fixed mortgage rates and the potential for a pullback in foreign buying add downside risk to the housing outlook. Even so, several factors, including a wave of millennials ageing into their prime first-time homebuyer years, increasing immigration, strengthening job growth, and our expectation that any further interest rate increases will proceed slowly, remain supportive of longer-term housing demand. After contributing an average of 0.2 percentage points to annual GDP growth since 2010, real residential investment is forecast to provide a modest drag on growth during 2017–18.

INVESTMENT STABILIZES

Economy-wide industrial utilization rates are near their long-term average, and capacity constraints in a number of industries, including several export-intensive sectors, should prompt a modest investment recovery through 2018 (Chart 6). Even so, we expect this firming in investment to be gradual: businesses remain relatively cautious in their expansion plans due to ongoing global economic uncertainty, weak profit growth, the introduction of country-wide carbon pricing in Canada, rising protectionist sentiment in the US, and the increasing cost of capital goods imports with a weaker loonie.

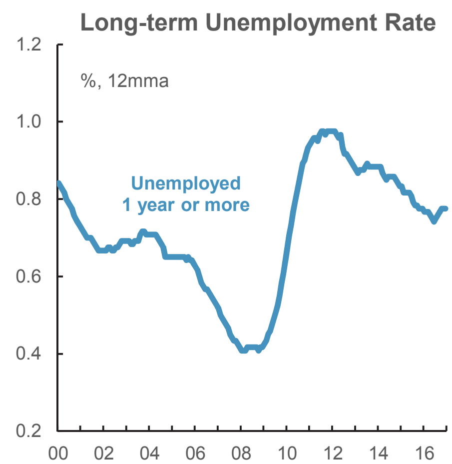
Investment growth in the resource sector will likely be flat or mildly positive. Oil and gas capital expenditures are only just showing signs of bottoming after the steep

Chart 3



Sources: Scotiabank Economics, Statistics Canada.

Chart 4



Sources: Scotiabank Economics, Statistics Canada.

Table 1 — Quarterly Canadian Forecasts

	2016				2017				2018			
	Q1	Q2	Q3	Q4e	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Economic												
Real GDP (q/q, ann. % change)	2.7	-1.3	3.5	2.5	1.8	2.2	2.0	2.0	2.0	1.9	1.9	1.9
Real GDP (y/y, % change)	1.3	1.1	1.3	1.8	1.6	2.5	2.1	2.0	2.0	2.0	1.9	1.9
Consumer Prices (y/y, % change)	1.5	1.6	1.2	1.3	1.9	1.9	2.3	2.2	2.0	2.0	2.1	2.1
CPIX (y/y % change)	2.0	2.1	1.9	1.7	1.7	1.7	1.8	1.8	1.9	1.9	1.9	1.9
Financial												
Canadian Dollar (USDCAD)	1.30	1.29	1.31	1.34	1.38	1.40	1.38	1.36	1.36	1.34	1.32	1.30
Canadian Dollar (CADUSD)	0.77	0.77	0.76	0.74	0.72	0.71	0.72	0.74	0.74	0.75	0.76	0.77
Bank of Canada Overnight Rate (%)	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.75	0.75	1.00
3-month T-bill (%)	0.45	0.49	0.53	0.46	0.50	0.50	0.50	0.50	0.60	0.80	0.90	1.10
2-year Canada (%)	0.54	0.52	0.52	0.75	0.75	0.85	0.95	1.05	1.20	1.35	1.45	1.60
5-year Canada (%)	0.68	0.57	0.62	1.11	1.15	1.25	1.30	1.40	1.50	1.65	1.80	1.90
10-year Canada (%)	1.23	1.06	1.00	1.72	1.75	1.80	1.85	1.90	1.95	2.10	2.20	2.35
30-year Canada (%)	2.00	1.72	1.66	2.31	2.35	2.30	2.35	2.45	2.55	2.65	2.75	2.80

cutbacks during 2014 and 2015. Firmer oil prices, which we expect to average around USD 58/bbl in 2017 should help to support energy investment. In mining, soft pricing and excess capacity will, however, continue to weigh on the investment outlook. The forestry sector faces a potentially complicated year with the strong likelihood of yet another protracted dispute with US industry groups before a new agreement on softwood lumber trade is reached.

NON-ENERGY EXPORTS BEGIN TO TURN A CORNER

The lagged effects of a weaker Canadian dollar, resilient US consumer demand, and firming business confidence in the US may now be starting to show up in Canada's non-energy export numbers. The largest non-resource segments of Canada's export portfolio have advanced considerably in 2016, with autos and parts (+12% ytd), consumer goods (+7%) and forest products (+4%) leading the way. Service exports, which currently account for a near-record 17% of overall export receipts (Chart 7), are expected to continue to grow at around 5%, led by rising business and personal tourism inflows attracted by a weaker CAD. Transportation and commercial services exports also continue to post steady gains of around 4% per year as household wealth increases, more families require additional educational and financial services, and businesses ramp up their online presence and technological capabilities.

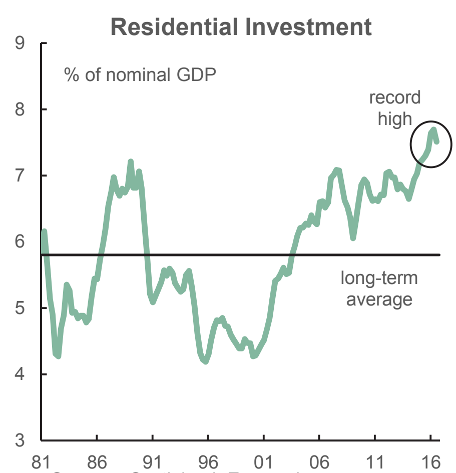
Canadian exports tend to track global demand closely (Chart 8), and the moderation in world growth in recent years has slowed Canadian export expansion. Canadian export growth has also been held back by a lack of spare capacity in export-intensive sectors, such as forestry and logging, transportation equipment, and food (Chart 6 again). Expectations for stronger global growth in 2017, led by the United States, some firming in Canadian investment, and higher energy prices should together support further modest export recovery.

It is still too early to factor in any major changes to Canada-US trade policy under the new US administration. The potential for an escalation in cross-border trade disputes, however, remains a notable downside risk to our forecast for exports and overall Canadian growth.

FISCAL STIMULUS SUPPORTS GROWTH

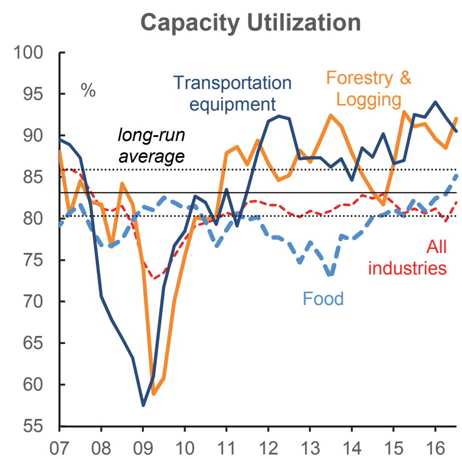
The public sector's solid contribution to Canada's real GDP growth in 2015 and 2016 is expected to rise from 0.4 percentage points to half a percentage point in 2017 before pulling back to 0.3 percentage points in 2018. This represents a substantial departure from the deficit reduction measures enacted during 2011–14, which made fiscal policy mildly contractionary. Ottawa's infrastructure plan, *Investing in Canada*, and other pre-existing programmes, are expected to double federal investment spending from 2016 to CAD 17.5bn by fiscal 2018–19. Any potential investment under the proposed Strategic Infrastructure Bank would add to these figures. Given the size and breadth

Chart 5



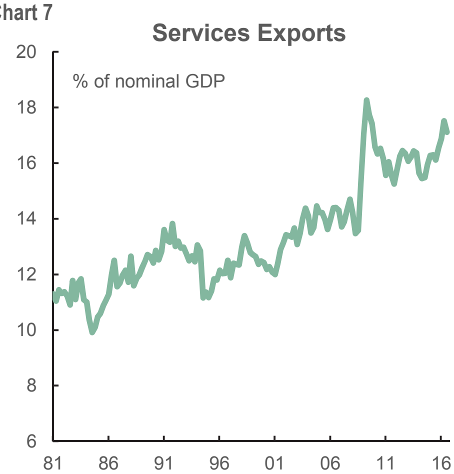
Sources: Scotiabank Economics, Statistics Canada.

Chart 6



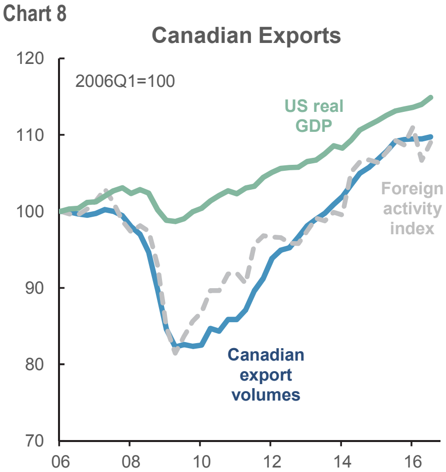
Sources: Scotiabank Economics, Statistics Canada.

Chart 7



Sources: Scotiabank Economics, Statistics Canada.

Chart 8



Sources: Scotiabank Economics, Statistics Canada, Bank of Canada.

of the planned infrastructure projects, allocated funding may not be fully deployed by 2018 when Phase 2 of *Investing in Canada* begins.

The provinces, territories, and municipalities are expected to match federal funding as required, while also continuing to invest in their own priority areas. In aggregate, projected growth in the operating expenditures of the junior governments over the next two years is expected to fall below anticipated population and inflation increases, and make no contribution to GDP growth.

KEY RISKS TILT TO THE POSITIVE

The key risks to Canada's outlook are mixed, but tilt toward the positive in the context of a stronger global economy. On the upside, higher-than-projected oil prices could boost growth and produce knock-on positive effects through several sectors. Similarly, an even stronger pick-up in US business activity and investment would produce a faster export turnaround. Canadian housing markets could perform more strongly than projected as Canadian growth picks up and real estate prices remain attractive to foreign buyers. On the downside, the risks are more diverse, but not necessarily more profound. Higher mortgage rates (see pp. 14–16) and tighter lending standards could dent housing-sector activity and squeeze already indebted Canadian households, with knock-on effects for the entire Canadian economy. Meanwhile, US corporate tax cuts and a more pro-growth regulatory policy agenda south of the border could further erode the relative competitiveness of Canadian business. US trade policy remains a significant unknown, but the Canadian government is engaging proactively to limit any possible damage.

Table 2 — Canada

	2000–15	2016e	2017f	2018f
		(annual % change)		
Real GDP	2.2	1.4	2.0	2.0
Consumer Spending	2.9	2.2	2.0	1.7
Residential Investment	3.8	2.3	-1.8	-0.8
Business Investment	2.7	-6.8	0.0	2.9
Government	2.2	1.8	2.1	1.5
Exports	1.3	1.0	2.3	4.0
Imports	3.1	-0.8	1.3	3.0
Nominal GDP	4.4	2.1	4.3	4.0
GDP Deflator	2.2	0.7	2.3	2.0
Consumer Price Index (CPI)	2.0	1.4	2.1	2.0
Core CPI (CPIX)	1.8	1.9	1.7	1.9
Pre-Tax Corporate Profits	3.9	-5.0	9.0	4.0
Employment	1.4	0.7	1.1	0.8
Unemployment Rate (%)	7.1	7.0	6.9	6.8
Current Account Balance (CAD bn)	-13.9	-69.3	-55.0	-43.0
Merchandise Trade Balance (CAD bn)	28.2	-31.1	-17.5	-8.5
Federal Budget Balance (FY, CAD bn)	-2.9	-1.0	-27.0	-32.0
per cent of GDP	-0.2	0.0	-1.3	-1.5
Housing Starts (000s)	199	198	190	185
Motor Vehicle Sales (000s)	1,639	1,949	1,940	1,925
Industrial Production	0.5	-0.7	2.0	1.6

The Provinces

THE VARIANCE IN REGIONAL GROWTH NARROWS

- **As recoveries gain traction in 2017–18 in Alberta and Saskatchewan—two major oil-producing economies—and industrial restructuring continues across all regions, rising infrastructure outlays will offer an offset to uneven business investment gains and some easing in housing activity.**

- **The Provinces' stepped-up capital investment in response to federal initiatives steepens the challenge of restraining their net debt burdens.**

Although regional adjustments to low commodity prices are well under way, their impact lingers. The more favourable interprovincial migration trends witnessed over the past year by most net oil-consuming provinces are expected to persist through at least 2017, expanding their available labour pools and limiting wage increases. With oil & gas investment recovering but still historically subdued, the 2017 rise in non-residential construction costs across Canada is expected to be relatively restrained.

Alberta's and Saskatchewan's forecast turnaround to positive growth in 2017, following a 5½% contraction in their combined real GDP during 2015–16, reflects higher oil production and a gradual pick-up in energy investment, particularly on conventional projects. Encouraging is the anticipated 2017 combination of WTI oil prices averaging USD58/barrel and a Canadian dollar softer than 75¢(US). Also supportive is the possibility of the Keystone and Trans Mountain pipelines now proceeding. Yet in the wake of major cost-cutting efforts, petroleum producers are expected to be cautious on re-hiring and other initiatives. With non-energy investment still correcting, Alberta's total business investment is expected to edge lower in 2017, even with Fort McMurray's reconstruction. Over the next two years, projected softness in potash prices is forecast to dampen Saskatchewan's recovery, while Newfoundland and Labrador's output and employment will be eroded as work progresses on a couple of major resource projects.

Growth in the high-flying BC and Ontario economies is forecast to moderate this year. BC is weathering a significant slowdown in its housing sector *(Chart 1)*, dampening related service activity and consumption into 2018. For the forest products sector in BC and other regions, the risk of adverse trade developments persists until a *Softwood Lumber Agreement* is signed. In Ontario, housing starts are expected to soften, and motor vehicle production to stabilize, albeit at high levels; but as in BC, momentum in financial and business services should help to sustain growth. In the Maritime provinces, Quebec, and Manitoba, after their soft landing in housing starts since 2012, a modest upturn leaves residential construction not far above recent lows. Thus, the projected robust upswing this year and next in transit, water treatment, road and social infrastructure across Canada is forecast to underpin growth.

Over the next two years, businesses and discretionary household income will be impacted by adjustments and hikes to a range of provincial and municipal levies. In part this reflects broad carbon-pricing frameworks, introduced in Ontario and Alberta in 2017 and in at least four other provinces in 2018, with further hikes in the minimum carbon price phased in through 2022. The existing regional variance in residential and industrial power prices *(Chart 2)* underlines the upcoming struggle among regions to remain cost competitive.

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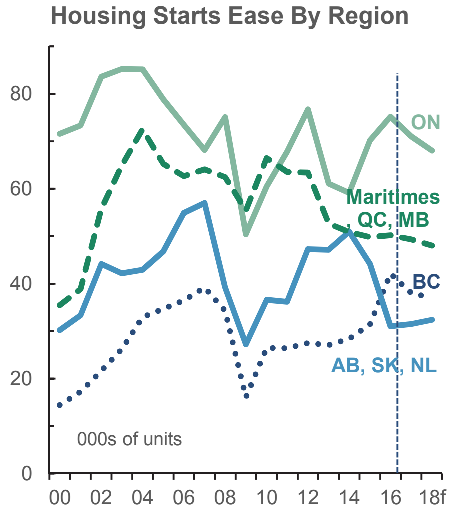
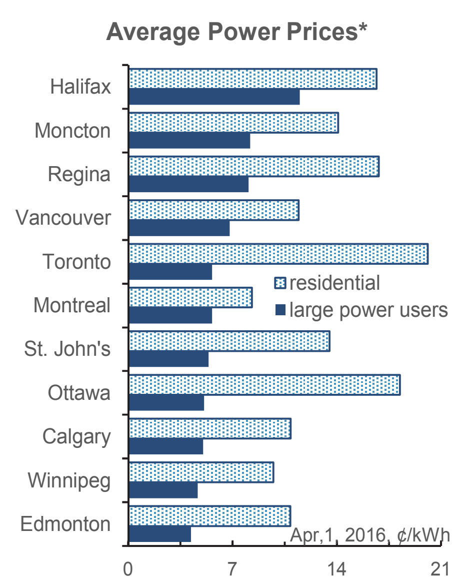
Chart 1



Sources: Scotiabank Economics, CMHC.

Chart 2



*Including taxes. Sources: Scotiabank Economics, Hydro-Québec.

THE FISCAL OUTLOOK

The Provinces' mid-year updates for fiscal 2016-17 (FY17) indicate an aggregate deficit close to $17 billion, $1 billion narrower than the *Budget* estimates, but $4.3 billion wider than FY16. The aggregate shortfall, however, masks the combined FY17 deficit of less than $3.5 billion (0.2% of GDP) across the seven net oil-consuming Provinces. In FY18, the deficit for these seven Provinces is expected to narrow to less than $1 billion as five of the Provinces target black ink. For the Provinces achieving or approaching balanced books, increased flexibility should facilitate participation in Ottawa's ambitious infrastructure and environmental plans.

As interest rates creep higher over the next two years, the Provinces, post-recession, have substantially lengthened the maturity of their debt. Risks remain, including retirement benefit obligations, renewable power expenses and the costs inherent in constructing or refurbishing major power generating or transmission capacity. A further challenge is preserving provincial competitiveness when global excess capacity persists in many industries. Potentially complicating this challenge is Trump's commitment to reduce the burden of government by cutting taxes and trimming environmental and other regulations.

Table 1 — The Provinces — annual % change, except where noted

Real GDP	CA	NL	PE	NS	NB	QC	ON	MB	SK	AB	BC
2000–15	2.2	2.5	1.8	1.4	1.2	1.7	2.0	2.4	2.1	3.1	2.7
2016e	1.4	0.3	1.3	1.3	0.5	1.6	2.6	2.1	-0.5	-2.7	3.1
2017f	2.0	-1.2	1.2	1.3	0.6	1.7	2.3	2.0	1.7	2.1	2.3
2018f	2.0	-0.9	1.3	1.2	0.6	1.6	2.3	1.9	2.0	2.4	2.3
Nominal GDP											
2000–15	4.4	5.7	4.3	3.3	3.3	3.6	3.8	4.5	6.0	6.5	4.5
2016e	2.1	-1.8	2.4	2.5	1.5	2.8	4.2	3.2	-2.8	-4.6	4.8
2017f	4.3	2.5	2.7	2.8	2.0	3.4	4.3	3.6	5.1	6.1	4.3
2018f	4.0	2.1	2.7	2.7	1.9	3.3	4.1	3.5	4.6	5.4	4.1
Employment											
2000–15	1.4	1.0	1.2	0.7	0.5	1.3	1.3	1.0	1.3	2.5	1.2
2016	0.7	-1.5	-2.3	-0.4	-0.1	0.9	1.1	-0.4	-0.9	-1.6	3.2
2017f	1.1	-1.3	0.4	0.3	0.3	1.0	1.3	0.6	0.2	0.5	1.5
2018f	0.8	-0.9	0.3	0.3	0.2	0.7	1.1	0.5	0.4	0.8	1.2
Unemployment Rate (%)											
2000–15	7.1	14.3	11.2	8.9	9.6	8.1	7.2	5.1	4.9	4.9	6.6
2016	7.0	13.4	10.7	8.3	9.5	7.1	6.5	6.1	6.3	8.1	6.0
2017f	6.9	13.6	10.5	8.1	9.4	6.9	6.4	5.9	6.2	7.9	5.9
2018f	6.8	13.7	10.4	8.0	9.2	6.8	6.3	5.9	6.1	7.6	5.9
Housing Starts (units, 000s)											
2000–15	199	2.7	0.8	4.3	3.6	44	71	5.1	5.2	35	28
2016	198	1.4	0.6	3.8	1.8	39	75	5.3	4.8	25	42
2017f	190	1.5	0.5	3.6	1.8	38	71	5.4	5.0	25	38
2018f	185	1.4	0.5	3.4	1.7	37	68	5.4	5.0	26	37
Motor Vehicle Sales (units, 000s)											
2000–15	1,639	28	6	48	37	410	624	47	45	216	178
2016e	1,949	34	8	55	43	465	802	56	51	220	215
2017f	1,940	32	7	54	42	463	796	56	52	223	215
2018f	1,925	30	6	54	42	459	788	55	53	226	212
Budget Balances, Fiscal Year Ending March 31 (CAD mn)											
2000–15	-2,917	59	-39	-31	-146	-953	-5,216	-84	425	1,746	291
2016	-987	-2,207	-13	-11	-261	2,191	-5,029	-846	-675	-6,442	730
2017f*	-27,000	-1,584	-8	12	-332	0	-4,324	-1,004	-1,044	-10,811	2,242
2018f*	-32,000	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

* FY17: Provinces' estimates, SK excluding pension accrual adjustment; history: MB:FY04–FY15 and AB:FY05–FY15.

United States

- **US growth is expected to accelerate from 1.6% in 2016 to 2.3% in 2017 as a broadly-based reflation of the US economy continues to take hold.**
- **The possibility of greater fiscal stimulus and deregulation from the new US administration implies the potential for even faster growth moving into 2018 so long as the new administration doesn't resort to protectionist trade policies.**

THE BUMP PRECEDED TRUMP

The US economy is strengthening following a weak start to 2016. We expect growth to continue accelerating to 2.3% in 2017 and 2.4% in 2018, about half a percentage point above the Fed's estimate of long-term potential. This pick-up is driven by a strong labor market and improved household balance sheets, which are translating into strengthening consumption, a turnaround in inventories, increased manufacturing sales—particularly in autos—and better prospects for investment. The rebound in global oil prices is also starting to provide a much more positive backdrop for the US energy sector, the epicenter of the US slowdown over the past year. A widening trade deficit is likely to be the only clear drag on US growth in 2017 and 2018. If the new US administration follows through on its stated tilt toward greater fiscal stimulus and deregulation, without also setting off a trade disruption, then the US economy will likely perform even more strongly than we currently anticipate.

ROBUST LABOUR MARKETS AND MORE CONFIDENT CONSUMERS

As the recent FOMC minutes indicate, the US is at or close to full employment: the unemployment rate is at 4.6%, initial unemployment claims are close to a four-decade low (Chart 1), the participation rate is increasing (Chart 1 again), and wage growth is accelerating (Chart 2). Hiring may slow as the economy converges to full employment, but continued real wage growth in a tighter labor market should permit real income growth to remain robust throughout 2017 and 2018.

Stronger labor markets combined with cleaned up household balance sheets are setting the stage for further acceleration in US growth: the household debt-GDP ratio has fallen about 20 percentage points from its 2008 crisis high (Chart 3) and the household debt-service ratio remains near a record low (Chart 3 again). Indicators of consumer confidence are at some of their highest levels since the 2008 financial crisis (Chart 4). More confident consumers with lighter debt burdens are likely to drive up consumption, increase demand for goods and services, and push up hiring and wages.

THE END OF THE INVENTORY CORRECTION

After years of slowing inventory accumulation in the face of uncertain growth prospects, inventory growth looks set to turn upward during 2017. The pace of sales growth is quickening across a broad range of industries, both in manufacturing and the vast service sector. In fact, purchases by households and businesses are now outpacing inventory accumulation for the first time since 2011 (Chart 5). Historically, a quickening in sales growth has usually led to some acceleration in the pace of inventory accumulation over the ensuing year.

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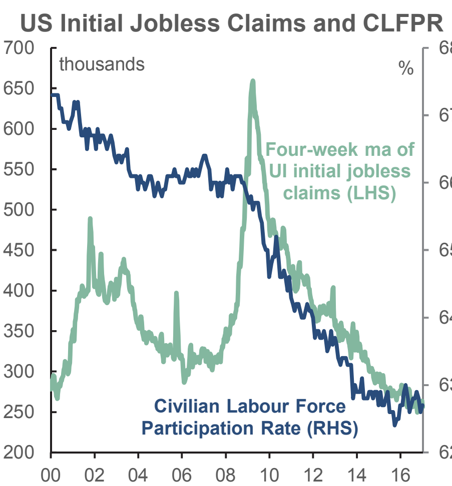
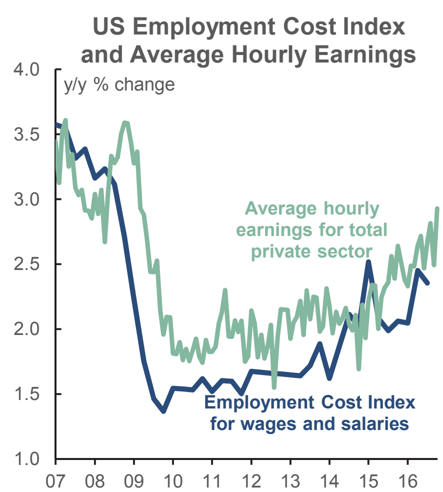
Chart 1



Sources: Scotiabank Economics, US Department of Labor, BLS.

Chart 2



Sources: Scotiabank Economics, BLS.

In particular, retail and wholesale purchases are now advancing in excess of 3% y/y for the first time in two years, which is more than double the pace of current inventory growth. This implies that store shelves will need to be restocked in the coming months, a crucial development for continued acceleration in US growth. Retail and wholesale inventories account for 60% of overall non-farm business supplies and nearly 10% of overall economic activity.

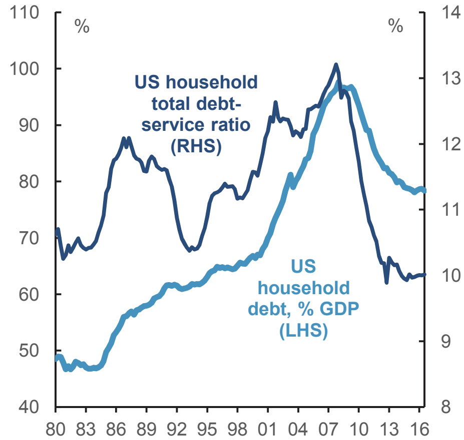
MANUFACTURING PICKS UP

Orders for manufactured goods began to gain momentum in the second half of 2016 and are now growing at their fastest pace in two years: they are outpacing overall output gains and point to even stronger US industrial activity ahead in 2017. In fact, the US Purchasing Managers' Index, a leading indicator of manufacturing activity, has been steadily improving since mid-year and ended 2016 at a buoyant 21-month high (Chart 6). Orders have increased for both durable and nondurable goods, with the high-tech sector leading the revival with gains of over 5% during the past year.

The auto industry has also been a key contributor to growth. US auto sales have climbed for seven consecutive years and have set back-to-back annual records in 2015 and 2016. Vehicle production has also been

Chart 3

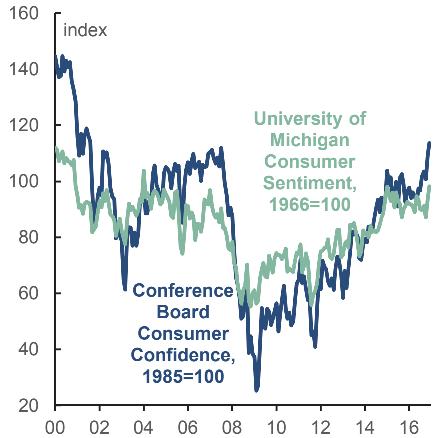
Cleaner Household Balance Sheets



Sources: Scotiabank Economics, Bloomberg, Federal Reserve.

Chart 4

US Consumer Confidence



Sources: Scotiabank Economics, The Conference Board, University of Michigan.

Chart 5

End of Inventory Correction

Sources: Scotiabank Economics, Census Bureau.

Chart 6

US Manufacturing Set To Rise

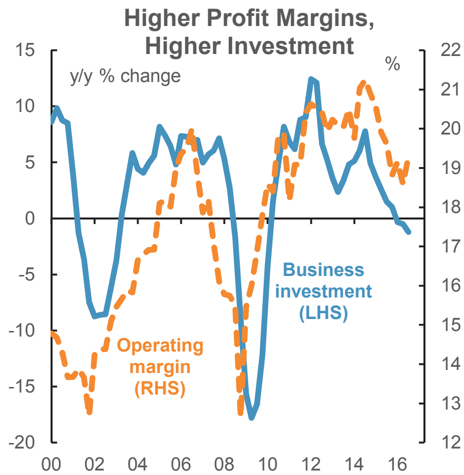
Sources: Scotiabank Economics, Federal Reserve Board, Institute for Supply Management.

Table 1 — Quarterly US Forecasts

	2016				2017				2018			
	Q1	Q2	Q3	Q4e	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Economic												
Real GDP (q/q ann. % change)	0.8	1.4	3.5	2.2	2.0	2.1	2.3	2.3	2.5	2.5	2.3	2.4
Real GDP (y/y % change)	1.6	1.3	1.7	2.0	2.3	2.5	2.1	2.2	2.3	2.4	2.4	2.4
Consumer Prices (y/y % change)	1.1	1.1	1.0	1.7	2.6	2.5	2.7	2.4	2.3	2.3	2.4	2.3
Core CPI (y/y % change)	2.3	2.2	2.2	2.1	2.1	2.1	2.2	2.3	2.3	2.3	2.3	2.3
Financial												
Euro (EURUSD)	1.14	1.11	1.12	1.05	1.02	1.02	1.05	1.10	1.12	1.12	1.15	1.15
U.K. Pound (GBPUSD)	1.44	1.33	1.30	1.23	1.20	1.20	1.25	1.25	1.30	1.30	1.35	1.35
Japanes Yen (USDJPY)	113	103	101	117	115	115	117	117	121	121	122	122
Fed Funds Rate (%)	0.50	0.50	0.50	0.75	0.75	1.00	1.25	1.50	1.50	1.75	1.75	2.00
3-month T-bill (%)	0.20	0.26	0.27	0.50	0.55	0.80	1.05	1.25	1.30	1.55	1.60	1.80
2-year Treasury (%)	0.72	0.58	0.76	1.19	1.25	1.40	1.50	1.70	1.75	1.90	1.95	2.10
5-year Treasury (%)	1.20	1.00	1.15	1.93	2.00	2.10	2.20	2.30	2.40	2.50	2.55	2.60
10-year Treasury (%)	1.77	1.47	1.59	2.44	2.50	2.60	2.70	2.80	2.85	2.90	2.95	3.00
30-year Treasury (%)	2.61	2.28	2.31	3.07	3.05	3.15	3.20	3.30	3.35	3.40	3.45	3.50

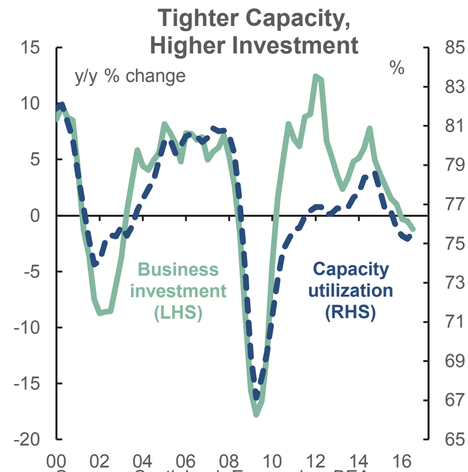
moving higher, lifting industry employment 2% over the past year and outpacing overall US employment growth for the seventh year in a row. We expect a further advance in 2017 as households continue to replace old vehicles. The average age of the US vehicle fleet has jumped to a record 11.6 years and there are more than 100 million vehicles on American roads that are older than average. Financing conditions also remain supportive, especially since more creditworthy buyers account for the majority of purchases and sub-prime's share of total financing volumes has been declining since mid-2015.

Chart 7



Sources: Scotiabank Economics, BEA.

Chart 8



Sources: Scotiabank Economics, BEA, Federal Reserve.

STRONGER BUSINESS INVESTMENT COMING

The stabilization in inventory growth, the pick-up in manufacturing orders, higher oil prices, and a year-long narrowing in corporate credit spreads have set the stage for an upturn in business investment. New orders for 'core capital equipment', a proxy for business investment, have advanced in five of the most recent six months. This has lifted machinery orders to their first quarterly increase in more than two years. This improvement has been concentrated in the oil and gas sector, which has since May 2016 boosted the number of rigs drilling by 50% and tripled its monthly purchases of machinery and equipment. In fact, the oil and gas sector has accounted for one-third of the overall advance in core capital equipment orders in the second half of 2016, significantly outpunching its traditional 8% share of overall capital expenditures. Outside of the oil and gas sector, business investment remains tepid: orders have fallen on a year-on-year basis since late-2014.

Past experience implies that growth in business investment hits its full stride only after both a double-digit improvement in profit margins has been attained and capacity utilization has tightened by roughly 2 percentage points. While growth in profit margins has troughed, it typically takes a year for profit growth to accelerate substantially (Chart 7). Meanwhile, capacity utilization in the US is still falling (Chart 8). Initial tax cuts and infrastructure spending by the incoming US administration may marginally quicken the present upturn in corporate earnings and profit margins, as well as improve operating rates. This would all hasten our expected rebound in business investment, but it is unlikely to bring it forward to any sooner than the second half of 2017.

HOUSING PROSPECTS REMAIN SOLID

Labor market gains, improved household balance sheets, and rising consumer confidence make the outlook for US housing positive: excess inventories have come down (Chart 9), increased participation by first-time buyers should continue to lift resale activity, new housing starts are on track to increase 8% in 2017, and prices are set to increase by 4% across major markets. Affordability remains better than the historical averages of major indices despite

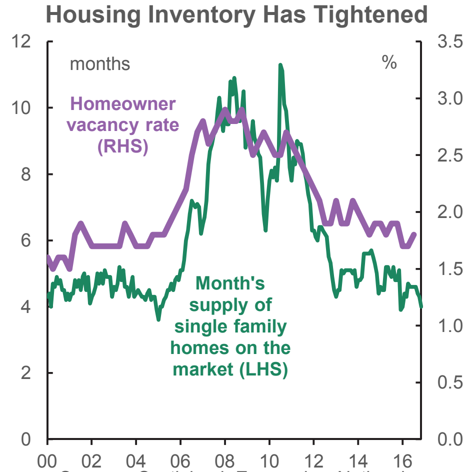
Table 2 — United States

	2000–15	2016e	2017f	2018f
		(annual % change)		
Real GDP	1.9	1.6	2.3	2.4
Consumer Spending	2.3	2.7	2.7	2.6
Residential Investment	-0.7	4.8	2.7	2.7
Business Investment	2.4	-0.5	2.1	3.2
Government	1.0	0.8	0.9	1.2
Exports	3.8	0.5	2.1	2.8
Imports	3.5	0.8	3.0	3.5
Nominal GDP	4.0	3.0	4.4	4.4
GDP Deflator	2.0	1.3	2.0	2.0
Consumer Price Index	2.2	1.3	2.5	2.3
Core CPI	2.0	2.2	2.2	2.3
Pre-Tax Corporate Profits	5.9	-0.5	5.0	3.0
Employment	0.6	1.7	1.4	1.3
Unemployment Rate (%)	6.3	4.9	4.6	4.5
Current Account Balance (USD bn)	-521	-484	-513	-545
Merchandise Trade Balance (USD bn)	-668	-735	-774	-825
Federal Budget Balance (USD bn)	-529	-587	-610	-650
per cent of GDP	-3.8	-3.2	-3.1	-3.2
Housing Starts (mn)	1.27	1.17	1.26	1.34
Motor Vehicle Sales (mn)	15.4	17.5	17.8	17.9
Industrial Production	0.8	-1.0	1.5	2.0

rising prices. Even so, the rates of both sales and price growth are expected to slow alongside the recent rise in mortgage rates. The 30-year fixed rate has climbed more than 70bps since early November to around 4.20% and home financing conditions since have eased only slightly.

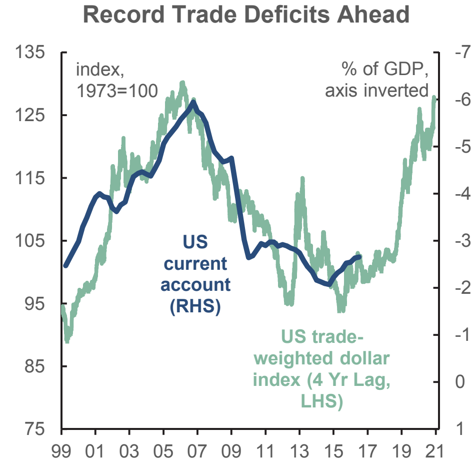
On the supply side, growth in the total volume of sales could be curbed by a lingering shortage of lower-priced listings: some potential move-up buyers remain reluctant or unable to list, while new construction has been geared toward higher-priced properties. Growth in total new housing starts may also slow as a result of construction labor shortages, permit delays, and rising land and construction costs. Meanwhile, a growing glut of high-end rental unit completions is expected to prompt a pullback in new apartment construction, which has accounted for roughly 30% of new homebuilding in recent years compared with a long-run average of 20%.

Chart 9



Sources: Scotiabank Economics, National Association of Realtors, Census Bureau.

Chart 10



Sources: Scotiabank Economics, Federal Reserve, Bloomberg.

FISCAL POLICY MILDLY STIMULATIVE

Fiscal policy is mildly simulative and looks set to remain so even without any additional measures under the new Trump administration. The federal deficit widened from 2.4% to 3.2% during fiscal 2016. Assuming a limited initial increase in spending, we expect the deficit to remain at 3.1% and 3.2% of GDP in fiscal 2017 and fiscal 2018, respectively. The White House may also try to demonstrate its commitment to reducing the burden of government by immediately using executive orders to trim some business levies and cut regulatory constraints, but their initial direct impact on the fiscal balance would be negligible.

Comprehensive tax reform, wide-ranging regulatory overhaul, and implementation of the mooted 10-year, USD 1tn increase in infrastructure spending are unlikely to begin taking effect until mid-2018, at the earliest. Until then, the uncertainty engendered by rolling policy shifts on the budget, the Affordable Care Act, climate change, and financial-sector regulation is likely to engender a "wait-and-see" approach to fiscal policy at the state and municipal level.

BIGGER TRADE DEFICITS AHEAD

Continued strength in the US dollar (USD, see pp. 42–43) and strong US demand are likely to lead to an ongoing deterioration in the US trade balance. As we've previously noted, the strong dollar could lead to record trade deficits over the longer term: the trade-weighted USD tends to anticipate eventual movements in the US current account balance (Chart 10). For the moment, net exports are expected to pare US growth by about 0.2 percentage points during 2017 and 2018, respectively. The emergence of even wider trade deficits would increase the risk that the new US administration will follow through on its threats to enact mercantilist trade policies, which would substantially dent both US and global growth.

RISKS FROM KNOWN UNKNOWNS

The United States economy's continued exit from secular stagnation hinges largely on the actions of the US authorities. With demand strengthening and the supply side responding, the US government doesn't need to do much to bring about quicker economic growth. A light touch on fiscal stimulus and the pursuit of the new White House's deregulation agenda could see even higher growth rates than we project here without eliciting a pre-emptory monetary policy tightening from the Fed (see pp. 14–16). In contrast, too much fiscal action at nearly full employment could prompt a quick hike in policy rates and a stronger USD. An ensuing widening in the US trade deficit would bring calls for higher tariffs, disruptions in trade with America's major economic partners, and a major reduction in growth, which would shake confidence in already highly-priced equity, corporate debt, and housing markets (see pp. 14–16) and hurt tax revenue. Similarly, a lack of follow-through on expectations of a consequential increase in infrastructure spending and regulatory reform would disappoint markets, which could have a material negative effect on both household and business demand and investment.

US & Canadian Monetary Policy & Capital Markets

The outlooks for monetary policy and broad market directions are so heavily interconnected that they require simultaneous consideration including risk scenarios.

FEDERAL RESERVE OUTLOOK—DEPENDS ON FISCAL MEASURES

The base case outlook for the Federal Reserve includes:

- three rate hikes this year followed by two hikes next year that would bring the fed funds target rate to 2% by the end of next year. At present, roughly 1½ hikes are priced into fed fund futures by the end of 2017.
- continued reinvestment of maturing Treasury, agency and MBS holdings that would preserve the level of the Fed's balance sheet at about $4½ trillion throughout 2017–18. We assume a gradual reduction in reinvestment of maturing holdings when rate normalization is "well underway" which we define to be around a fed funds target rate of 2% or higher.

Given the present composition of the FOMC, the risk to this base case is somewhat more heavily skewed toward fewer hikes (chart 1) and later phase-out of reinvestment. We may re-evaluate this risk should hawkish appointees fill two vacancies this year and replace Chair Yellen and Vice Chair Fischer in 2018H1.

Our base case Fed outlook assumes further improvement in the economy as discussed in the fundamentals outlook for the US economy on pp.10–13, and how that translates into the Fed's dual mandate to foster price stability and full employment. Wage growth at its fastest pace in over seven years presents cost-push inflation pressures contributing to our forecast for a sustained return to 2% inflation. More pricing power will also accompany the elimination of spare capacity as measured by the US output gap (chart 2). The strong USD mitigates some inflationary pressure that we estimate will shave a few tenths off of headline inflation if dollar strength sticks. Market-based inflation expectations have increased, including TIPS break-evens and inflation swaps, while survey-based measures are mixed with economists forecasting rising inflation as consumer confidence surveys signal slightly declining price pressures.

This forecast would continue extraordinarily easy monetary policy compared to a "Taylor Rule" or any other mechanistic approach to setting monetary policy. It would keep the inflation-adjusted 'neutral' policy rate near zero by the end of 2018 and thus a percentage point below the FOMC's long-run projection.

The risk of faster-than-forecast rate hikes is heavily dependent upon the exact nature and course of fiscal and regulatory stimulus net of trade policy. At this juncture, we judge this risk to be exceptionally difficult to evaluate. As Spring and Summer approach, we expect to have more information on broader policy risks.

International risks—such as global trade policy responses to potential US measures, European elections, OPEC's ability to enforce production cuts and influence firm or higher oil prices, China's economy, or potential geopolitical conflict—and risks to stretched asset valuations—discussed in a moment—**are why we shave the risks to the downside of our base case rate projection.**

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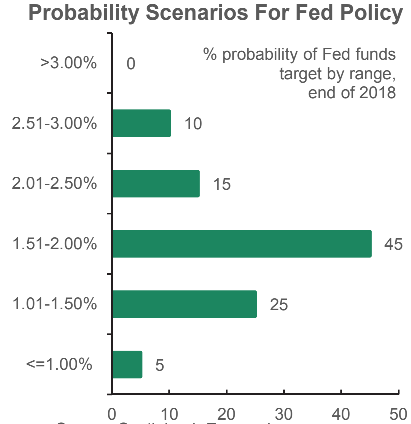
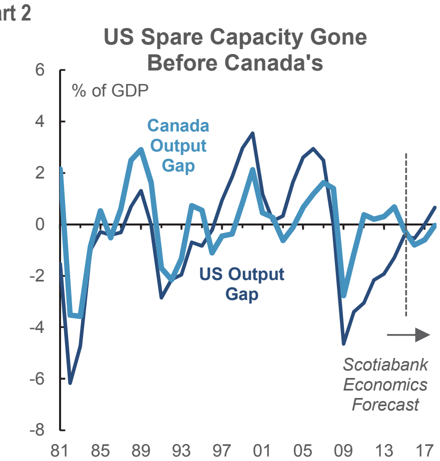
Chart 1



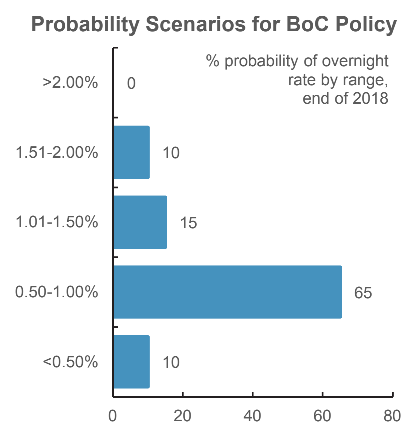
Source: Scotiabank Economics.

Chart 2



Sources: Scotiabank Economics, Bank of Canada, IMF, Congressional Budget Office.

Chart 3



Source: Scotiabank Economics.

BANK OF CANADA OUTLOOK—LAGGING THE FED

The base case for the Bank of Canada is for no rate changes this year, followed by two quarter-point hikes starting in mid-2018 that would raise the overnight rate to 1% by the end of next year. See chart 3 for probabilities surrounding this projection.

We think the Bank of Canada will lag well behind the Federal Reserve in raising interest rates for several reasons. One is that Canada has a little more disinflationary economic slack that we expect to close only by 2018H2–19 (chart 2 again). Two is that headline inflation is expected to approach the 2% policy target, but core inflation that serves as more of an operational guide to inflation targeting is more uncertain and may not sustainably reach 2% until 2018 or later. The BoC has adopted three new measures of core inflation, including the preferred common component CPI metric, that will prove very difficult to forecast and may raise communication challenges. Further, wage inflation has decelerated to barely over 1% in Canada whereas it is about twice as fast in the US. In terms of fundamentals (see pp.4–7 for more), all-time highs in multiple measures of household activity combined with rising fixed borrowing costs and ongoing tightening of macroprudential rules suggest a cautious monetary policy approach. Export growth will be relied upon more heavily in a rebalancing of growth, but far more evidence of improvement on this count will be required for the BoC to have enough conviction to pull away the punchbowl especially given NAFTA risks and the prospect of a US border tax that can be likened to the Smooth-Hawley tariff of 1930.

Further, the outlook for Canadian monetary policy is heavily conditioned on the outlook for the Federal Reserve. There is indeed a limit to monetary policy divergence in the two economies in our view. We believe that the limit to undershooting the Fed's policy rate will be reached into 2018 when our forecast maximum spread of 100bps under Fed funds is reached (though it was much wider in the early 1990s).

Various forms of currency risk in the context of a very highly valued US dollar pose elevated uncertainty to our Bank of Canada outlook. BoC research (here) has indicated that every 10% trade-weighted depreciation in the Canadian dollar lifts headline CPI inflation by 0.6% and core inflation by 0.3% over the longer run, but that the effects are fairly transitory. A major trade policy shock, for instance, could prompt a swifter depreciation in CAD that could complicate BoC policy.

At this juncture and in the face of elevated uncertainty toward factors such as US policy, we judge the risk to this outlook to be fairly balanced.

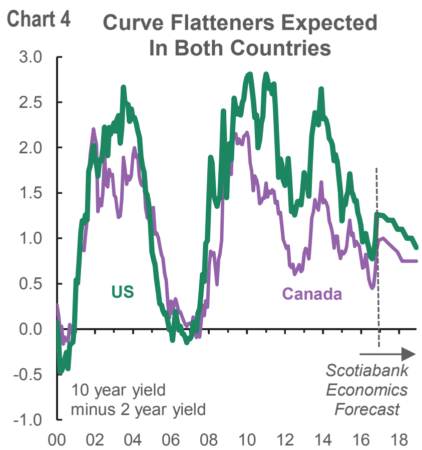
YIELD CURVES—BEAR FLATTENERS, CANADA TO OUT-PERFORM

Scotiabank Economics forecasts the US Treasury and Government of Canada yield curves to bear flatten over our forecast horizon by a 2yr10yr convention (chart 4). The faster rise in shorter-term yields than longer-term yields is conditioned on the belief that monetary policy will tighten over our forecast horizon, but that there are cyclical and structural limits to the extent to which longer-term bond yields can rise.

Much of this report focuses upon nearer-term cyclical influences such as improved growth and higher inflation, but in more limited fashion than at this stage of historical business cycles. Continued stimulus by foreign central banks (including ongoing bond purchases by the ECB and BoE plus a combination of purchases and a yield cap set by the Bank of Japan) maintains their significant involvement in their bond markets. That should continue to set a lower ceiling on rising foreign bond yields and, as a result, widened US Treasury spreads become more attractive to global fixed income portfolio managers. Fiscal stimulus can only go so far in possibly raising longer-run potential growth in the economy that faces headwinds such as an aging workforce.

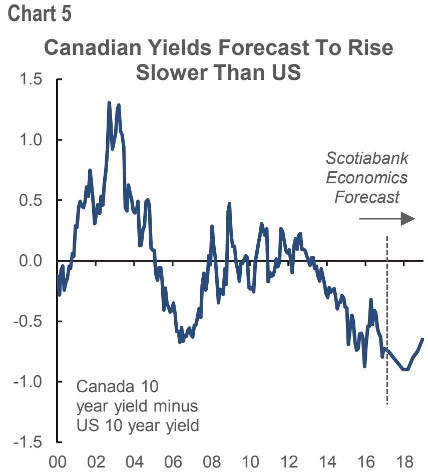
Indeed, upside risks to our longer-term yield forecasts include higher deficit-financing of fiscal stimulus in Canada and, most notably, the US. Studies by Hubbard et al (here) and Orszag and Gale (here) found that every one-percentage point rise in the US debt-to-gdp ratio raises the real interest rate by 2-7bps. Deficit repair and QE programs may have broken this relationship in the Global Financial Crisis era but the return toward full-employment, the end to QE at the Fed, and the risk of a blow-out in deficits may resurrect such a relationship with detrimental effects on global bond markets. This issue bears careful monitoring from the standpoint of many of our team's forecasts.

Chart 4



Sources: Scotiabank Economics, Bloomberg.

Chart 5



Sources: Scotiabank Economics, Bloomberg.

The risk of lower yields than forecast comes partly from geopolitical developments such as European elections and sundry potential disturbances that could drive safe-haven demand A debt ceiling conflict that mitigates or jeopardizes net fiscal stimulus plans and the risk of retaliatory trade measures could also put downward pressure upon yields as could an abrupt correction in risk assets.

Longer-run Canadian rates are expected to rise less rapidly than US yields (chart 5). This is because of less potential upward pressure upon deficits and a AAA Government of Canada rating, somewhat greater economic slack, less full-cycle inflation risk in the face of a mature household cycle, and potential risk from US protectionism. Total exports are one-third of Canadian GDP.

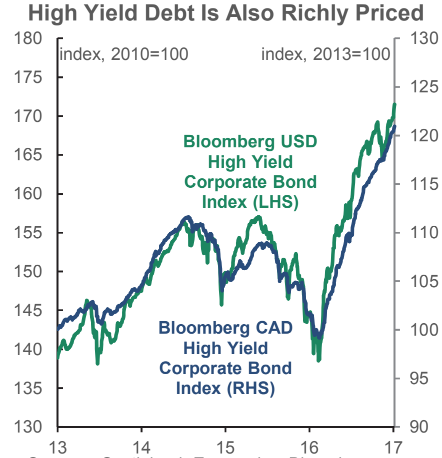
MULTIPLE ASSET CLASSES ARE RICHLY PRICED

Among the market risks to the monetary policy and macroeconomic outlook is how rich multiple measures of asset valuations have become. Potential gains resulting from 'Trumponomics' have arguably been largely priced, leaving scope for disappointment if execution fails. Monetary policy is not immune to the risks posed to financial stability and feedback effects on growth stemming either from excessive froth—such as in the lead-up to the Global Financial Crisis—or abrupt corrections. Forecasting peaks and troughs across valuations and timing them is extraordinarily difficult, but **one would be remiss not to end this note with a caution about high valuations.**

- US equity values are at their richest since the dot-com era. This is true in terms of multiple measures like trailing price-to-earnings, forward P/Es, Shiller's cycle smoothed P/E, Tobin's Q (price to replacement cost), and a 2% S&P500 dividend yield. Equity valuations reflect a 'Trump effect' and if policy execution is imperfect then valuations may be disappointed;
- The broad-dollar index is at its highest since the dot-com era and suggests a sharp widening of the US current account deficit that may further intensify protectionist sentiment in Washington;
- US high yield debt has risen by about 70% since the end of 2009 and energy-dominated Canadian high yield debt has risen to higher prices than existed when WTI oil was trading around $90 per barrel (chart 6);
- BAA rated US corporate bond spreads over 10 year Treasuries are nearing the post-crisis low set in 2014 before oil prices fell;
- US home prices are now just above where they were on average at the pre-crisis peak in 2006 according to the S&P Corelogic Case-Shiller home price index. Canadian home prices are lofty by multiple yardsticks.

Chart 6

High Yield Debt Is Also Richly Priced



Sources: Scotiabank Economics, Bloomberg.

Table 1 — Scotiabank Economics' Canada-US Yield Curve Forecast

	2016				2017 (end of quarter, %)				2018			
Canada	**Q1**	**Q2**	**Q3**	**Q4**	**Q1f**	**Q2f**	**Q3f**	**Q4f**	**Q1f**	**Q2f**	**Q3f**	**Q4f**
BoC Overnight Target Rate	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.75	0.75	1.00
Prime Rate	2.70	2.70	2.70	2.70	2.70	2.70	2.70	2.70	2.70	2.95	2.95	3.20
3-month T-bill	0.45	0.49	0.53	0.46	0.50	0.50	0.50	0.50	0.60	0.80	0.90	1.10
2-year Canada	0.54	0.52	0.52	0.75	0.75	0.85	0.95	1.05	1.20	1.35	1.45	1.60
5-year Canada	0.68	0.57	0.62	1.11	1.15	1.25	1.30	1.40	1.50	1.65	1.80	1.90
10-year Canada	1.23	1.06	1.00	1.72	1.75	1.80	1.85	1.90	1.95	2.10	2.20	2.35
30-year Canada	2.00	1.72	1.66	2.31	2.35	2.30	2.35	2.45	2.55	2.65	2.75	2.80
United States	**Q1**	**Q2**	**Q3**	**Q4**	**Q1f**	**Q2f**	**Q3f**	**Q4f**	**Q1f**	**Q2f**	**Q3f**	**Q4f**
Fed Funds Target Rate	0.50	0.50	0.50	0.75	0.75	1.00	1.25	1.50	1.50	1.75	1.75	2.00
Prime Rate	3.50	3.50	3.50	3.75	3.75	4.00	4.25	4.50	4.50	4.75	4.75	5.00
3-month T-bill	0.20	0.26	0.27	0.50	0.55	0.80	1.05	1.25	1.30	1.55	1.60	1.80
2-year Treasury	0.72	0.58	0.76	1.19	1.25	1.40	1.50	1.70	1.75	1.90	1.95	2.10
5-year Treasury	1.20	1.00	1.15	1.93	2.00	2.10	2.20	2.30	2.40	2.50	2.55	2.60
10-year Treasury	1.77	1.47	1.59	2.44	2.50	2.60	2.70	2.80	2.85	2.90	2.95	3.00
30-year Treasury	2.61	2.28	2.31	3.07	3.05	3.15	3.20	3.30	3.35	3.40	3.45	3.50

Mexico

STRUCTURAL ADJUSTMENT UNDER WAY: LOWER GROWTH AND HIGHER INFLATION IN FOCUS

- **Shifts in monetary and trade policies by the US government will likely affect Mexico's outlook.**
- **The ongoing commitment to fiscal consolidation and structural reforms is a positive factor.**
- **Mexico's currency outlook is vulnerable to Fed-induced risk-repricing in emerging markets.**
- **Our revised 2017 forecast implies lower GDP growth, a weaker currency, and higher inflation.**

The new year is starting on a volatile note. The Mexican peso depreciated to nearly 22 pesos per USD after ending 2016 close to USDMXN 20.75. This forced a direct intervention from Banco de Mexico in the FX market, which had not been observed for many years. Our MXN forecast assumes that pressure will continue throughout 2017 to end the year around USDMXN 22.3. Perceptions of potential shifts in US trade, immigration, and monetary policy that affect the US-Mexico bilateral relationship are at the core of this currency market volatility—which is in stark contrast to the appreciating bias observed in regional currency peers such as the Brazilian real.

In the near-term, Mexican growth is being held back by a number of factors. The related deterioration in public finances led rating agencies to put Mexico's sovereign-debt outlook into negative territory during 2016. The federal government has taken this issue quite seriously, and as a consequence, many measures have been put in place to improve public finances. These include spending cuts and the recently announced increases in transportation fuel prices. Prices jumped 14.2% above the national average for regular-grade gasoline, 20.1% for premium-grade 'Magna' gasoline, and 16.5% for diesel, while the domestic natural gas price increased by more than 13%. All these adjustments will reduce disposable income and have a significant impact on inflation. The immediate direct impact on January's inflation rate is close to 0.8 percentage points (pp), plus an extra impact of close to 0.2pp once price increases for public transport (not including the Mexico City subway) and taxis are authorized. Our estimate for January's inflation rate is around 1.4% m/m, which, if underlying trends continue for the remainder of the year, would translate into full-year inflation of 5.5% in 2017. Even though this should be a one-off effect, there is a significant risk that inflation dynamics could be affected further in the coming years owing also to the lagged impact of the depreciation of the peso. As a consequence, tighter monetary policy from Banco de Mexico is likely in the months ahead, with the reference interest rate expected to reach 7.5% before year's end. This too will dampen growth.

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Chart 1

Sources: Scotiabank Economics, Bloomberg.

The high level of uncertainty that has prevailed since the US elections has put many investments on hold. Public spending cuts are heavily focused on the capital side, and consequently, infrastructure spending is expected to be very weak and will hold back total investment. In addition, higher interest rates, higher inflation, and greater currency depreciation should weigh negatively on this year's investment numbers where we anticipate a contraction of 2.4%. Private consumption is also expected to be affected by all these adverse conditions, including by social unrest in response to recent transportation-fuel price adjustments. Our new forecast for 2017 for private consumption growth is 1.8%.

Given these factors, we now expect growth of 1.5% in 2017, a significant slowing from the 2.1% pace registered in 2016. Significant variation is expected across the different sectors of the economy, with oil extraction and oil related industries, heavy construction, and chemical industries the most negatively affected, while some services branches such as communications and financial services have a more positive outlook.

Despite slower growth in 2017, longer-term Mexican growth prospects remain favourable. Reform of Pemex and the regime governing investment in the oil and gas sector is well underway, and this should lead to stronger capex and energy production in Mexico. Also, the authorities' commitment to reform and prudent macroeconomic policies remains solid. Our assessment is that the framework put in place by the Mexican government will provide macroeconomic stability, which is essential to stronger growth in the future. Finally, the US and global economies are accelerating. Given Mexico's openness, stronger growth in its major trading partners should fundamentally benefit Mexico's economy.

United Kingdom

- **The UK economy continues to expand at a trend pace, but is likely to slow progressively throughout 2017.**
- **We expect CPI inflation to rise sharply in the coming months, from 1.2% y/y in Q4 2016 to 2% y/y in February and a peak of 3% y/y in late-2017.**
- **While we forecast that the BoE will remain on hold for the next two years, there is likely to be speculation of moves (in either direction) throughout this year.**

SUMMARY

The UK is starting 2017 with decent momentum in activity. The PMI surveys are in mid-50 territory and the quarterly pace of GDP growth is in line with trend. Article 50 has not yet been triggered and the UK will remain in the EU at least until H1-2019. The possibility of a transitional agreement could even mean that the UK's current trading arrangements with the EU are maintained beyond that date. The point is that it is business as usual for now. Brexit-related uncertainty may cause some incremental downside for investment or hiring over the coming period, but the UK has avoided falling off a cliff.

GROWTH

Over the coming year the main influence on the macro outlook is likely to be the sharp fall in the exchange rate. While there are some positive implications of this move, we judge that the negatives will dominate. On the positive side, the weak GBP exchange rate represents a sharp loosening in financial conditions and is probably responsible for propelling business sentiment to above the pre-referendum levels. The flipside is that the weaker exchange rate is raising imported inflation and hence costs. This will cause a squeeze on profitability in many sectors and will be a major burden on household real disposable income growth. The latter is the main reason that we expect GDP growth to slow during 2017.

More specifically, CPI inflation has already risen from 0% y/y to just above 1% y/y and should hit 3% during H2-2017. In isolation, that will subtract three percentage points from real disposable income growth. Furthermore, with employment growth already slowing from 2% y/y down to its long-run average of 1% y/y, we judge that real disposable income growth will stall during H2. While we do expect higher inflation to ultimately push wage inflation higher, we doubt that will happen until 2018. The slowdown in real disposable income points to slower household consumption and hence overall GDP growth.

To keep things in context, our forecast for 1.6% y/y GDP growth during 2017 is in line with US GDP growth during 2016 and not far below our forecast of 1.8% growth in 2017 for Germany (the powerhouse of the eurozone). So this is far from a disaster and probably temporary. That said, we forecast that quarterly GDP growth will fall to as low as 0.2% q/q during H2, which is a pretty feeble pace.

CONTACTS

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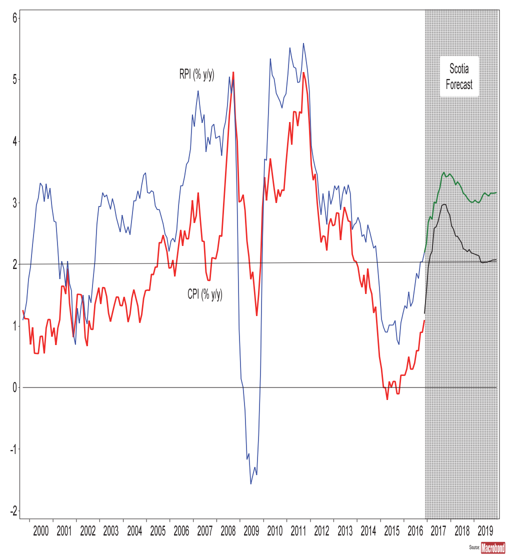
Chart 1

UK Inflation Forecast



INFLATION

Having gradually moved higher since mid-2016 (from ½% y/y to just above 1% y/y), CPI inflation is about to rise more sharply. We expect CPI inflation to hit 2% y/y by February, 2½% y/y by Easter and peak at 3% in the autumn. Clearly, the weaker GBP exchange rate is the main reason to expect inflation to accelerate. We also expect some second round effects to reinforce the rise. However, we expect the peak in inflation to be lower than it was the last time the pound fell by a similar amount. More specifically, inflation hit 5% in 2011, but this was partly due to several one-off influences. We also suspect that domestically generated inflation will be held back by subdued demand. This will limit the extent of the upside for headline CPI inflation.

Unless the pound continues to weaken, the uplift from rising imported inflation should begin to dissipate at some point. We judge the lead time between the fall in the pound and the maximum impact on inflation to be 9 months. This should mean that inflation will peak in late-2017, before slowing the following year to low-2% territory by late-2018.

FISCAL POLICY

The new Chancellor presented his first mini-Budget in November. While there was a bigger-than-expected increase in the level of government borrowing, relatively little of this was due to discretionary policy easing. The structural deficit is still forecast to narrow over the coming five years, but by an average 0.2% of GDP slower per year than previously forecast. We believe that the resilience of the activity data in the aftermath of the Brexit vote reduced the urgency to loosen fiscal policy. Further easing could still be an option, particularly if GDP growth disappoints during 2017. Such a situation would only become compelling around the time of the autumn Budget statement. For now, we would expect the government borrowing estimate to be revised up by close to GBP20bn in the spring Budget, mainly due to the rise in the government debt interest burden resulting from higher bond yields.

MONETARY POLICY

2017 is likely to be a year of two halves for monetary policy. Solid activity data at the end of 2016 means that another Bank Rate cut and an expansion in the QE programme are unlikely any time soon. In fact, with inflation rising sharply during the first half of the year, we would expect to see speculation that the BoE could turn hawkish.

By contrast, H2 is likely to see GDP growth slow to just above 0% q/q. This may fuel speculation about possible BoE loosening at that point, or even a dissent among the MPC, despite elevated inflation.

The bottom line is that while we expect BoE policy to be unchanged though 2017 and 2018, there is likely to be speculation of policy moves in both directions over the coming year.

Eurozone

- **Eurozone growth is re-accelerating, and stronger-than-expected external demand could create an upside surprise.**
- **Inflation will temporarily move closer to 2.0% y/y in Q1, while core inflation is forecast to gradually rise.**
- **The ECB could gradually turn more hawkish.**

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ACCELERATING ECONOMIC GROWTH…

Recent months have strengthened our scenario of stronger growth at the turn of the year.

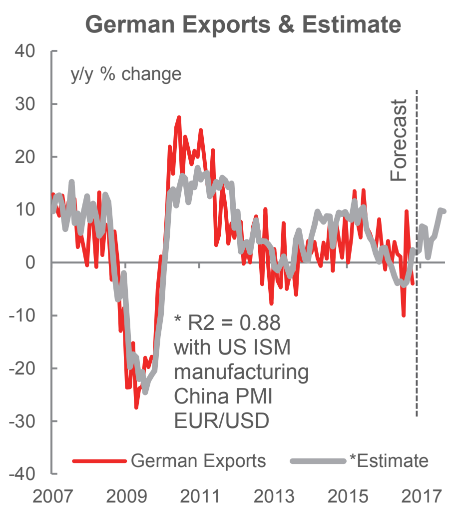
Although the recovery on the supply side of the economy is still lagging with Eurozone manufacturing production showing flat growth in October/November relative to Q3, the demand and export side of the Eurozone has clearly strengthened in the final quarter of 2016. Indeed, retail sales sharply rebounded in October, while consumer confidence reached its highest level in almost two years in December. In the meantime, exports increased for the third month in a row in October. In view of this data, Q4 Eurozone real GDP could expand by around 0.5% q/q, up from 0.3% in the previous two quarters.

Furthermore, rising business confidence points to ongoing strength at the beginning of the year. In view of historical elasticity, Eurozone real GDP in Q1 could register growth of close to 2.0% y/y, implying a 0.5/0.7% q/q increase. This would likely create arguments for a potential upward revision to the ECB's Eurozone growth projection this year, which is presently forecast to rise by 1.7%.

Looking beyond this short-term cyclical acceleration, it is also helpful to address the other underlying drivers of Eurozone growth. Compared to three months ago, there have not been many changes in the stimulus offered to the area. Indeed, while the recent drop of the euro offers a stronger support for corporates' competitiveness, it is offset by the adverse impact of higher oil prices on households' purchasing power and consumption. In the meantime, the stimulus offered by fiscal policy to Eurozone real GDP seems to be roughly the same as assumed three months ago, at around 0.2% of GDP and the rise in interest rates has, so far, remained limited, thus continuing to offer favourable financial conditions. So, all in all, we maintain the view that the positive impact of both monetary and fiscal policy could add roughly 0.5 percentage points to GDP this year. With Eurozone potential growth estimated at around 1.1% by the EU Commission, a growth scenario of between 1.5% and 1.7% for 2017 looks valid.

However, the upward surprise could come from stronger-than-expected external demand. Indeed, global business sentiment has remained surprisingly resilient despite rising political uncertainties following the UK's vote to exit the European Union and the surprise election of Donald Trump as the US President in November. The global PMI manufacturing index has returned to its highest level in two years, which points to stronger export growth than previously anticipated. As an example, we estimate that German export growth—the benchmark by which to assess how global demand is supporting Eurozone exports—could be rising by

Chart 1: Exports To Pick Up



around 10% y/y in H2 2017. Resilient business sentiment could provide further comfort at a time when the Eurozone is also set to face potential major political shocks, with numerous general elections in core countries scheduled this year (the Netherlands, France and Germany). Stronger global demand could encourage the ECB to revise its growth scenario up at its March meeting.

… AND INFLATION

On the back of higher energy and food prices, Eurozone inflation closed 2016 at 1.1% y/y, its highest level in three years. In view of Brent prices at around $55 per barrel and the adverse impact of colder-than-usual temperatures on fresh food prices, we expect Eurozone inflation to reach a peak at around 1.7% y/y in February. In the short-term, headline inflation will remain very sensitive to the swings in oil prices with, according to our estimate, any $10 shift in Brent prices impacting Eurozone inflation by around 0.4%/0.5% over a 12 month horizon.

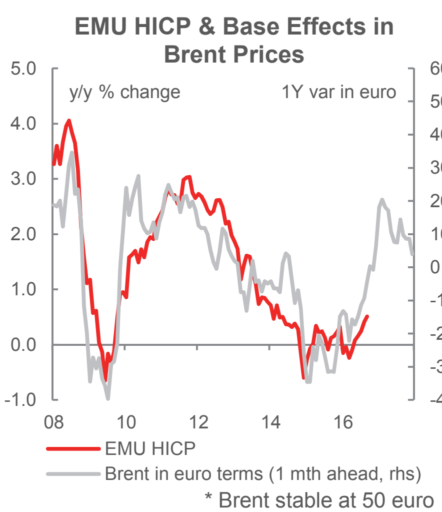
Beyond this, as the impact of favourable base effects from energy prices gradually fades away, much will depend on the capacity of core inflation to pick up. Indeed, core inflation has remained stuck at a low level of around 0.8%/1.0% y/y over the past year. Two factors, however, could support some recovery in the quarters ahead:

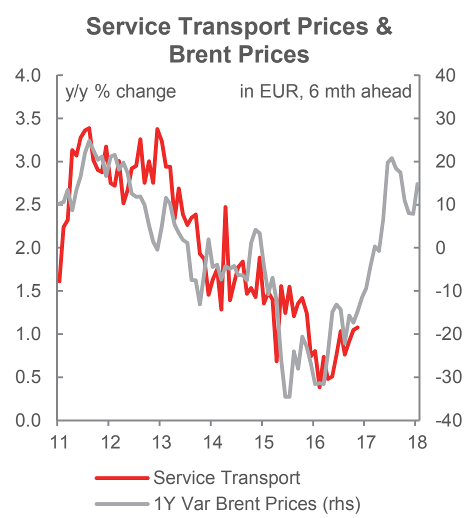
- First, we suspect that part of the weakness reflects the lagged impact of the drop in oil prices on service transport and non-durable goods prices. Past elasticity between these two components and oil prices suggests that the drop in oil prices has negatively impacted Eurozone core inflation by around 0.2% in 2016. Thanks to higher oil prices, service transport and non-durable goods prices should now contribute to pushing core inflation up by around 0.3%/0.4% in 2017. Latest data in service transport prices seem to already be reacting to the turnaround in oil prices.

- Second, core inflation has been depressed by lacklustre wage growth. As the job market continues to improve, we could see stronger support for wages, and therefore, core inflation. Indeed, there is a one-year lag between lower unemployment and wages. Empirical evidence suggests that a 1 percentage point drop in the Eurozone unemployment rate over the past year should contribute to lifting wage growth by around 0.5% y/y and core inflation by 0.2%.

All in all, at this stage, we expect core inflation to rise to around 1.1%–1.2% y/y in H2 2017 and move closer to 1.4% y/y at the beginning of 2018. However, we admit that there could be downside risks to this forecast. Indeed, given that the improvement in the labour market reflects a rising share of temporary contracts, there could be a lower elasticity between the drop in unemployment and wage growth. As well, ongoing underlying weakness in the banking sector could also act as a drag. This can be seen by the correlation between the performance of bank equity prices and the trend in core inflation. This strong relationship illustrates the importance of the banking sector in Europe for the efficient transmission of monetary policy, and therefore, the ECB's capacity to "reflate" the Eurozone economy through the credit channel.

Chart 2: Headline Inflation & Service Transport Prices With Oil Prices



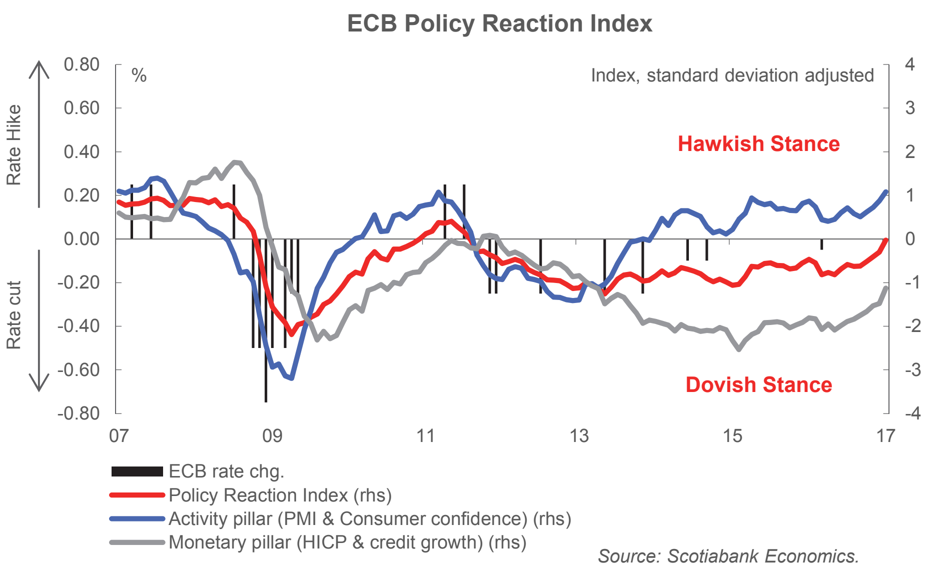


COULD THE ECB TURN HAWKISH?

In December, the ECB decided to prolong its QE by 9 months, up to the end of December 2017 with monthly asset purchases of €60bn beginning in April, down from €80bn currently. Despite the program extension, the downward shift in monthly asset purchases indicates to us a gradual shift inside the ECB towards an end to aggressive monetary accommodation. Although the ECB kept the option of increasing the program in case of less favourable financial conditions, the central bank will now be more re-active than pro-active and the board will likely become more sensitive to upcoming macroeconomic data. In view of the Eurozone's current economic dynamic, there are arguments to suggest that the tone of the ECB board could gradually become less dovish.

We have updated our indicator on the ECB's policy reaction which, in the past, used to be a reliable index to track the shift in the monetary policy. It is based on two factors: monetary conditions and economic activity. The monetary pillar tracks the deviation of headline inflation to the ECB's price target of 2.0% as well as credit growth. The activity pillar is based on the deviation of both the PMI manufacturing and consumer confidence index. Both pillars are assessed relative to their long term averages and are evaluated jointly to determine if conditions warrant a more "hawkish" or "dovish" central bank policy stance. In view of recent data, chart 3 indicates that the activity pillar is already well above its long term average, while the monetary pillar is improving but remains well below its long term average. Taken together on average, our ECB policy reaction index is now back in line with its long term average, implying that the ECB is likely in "wait-and-see" mode. However, in view of the expected improvement in upcoming inflation data, the signal sent by the monetary pillar should further improve, pushing our ECB policy reaction index gradually above its long term average, on the "hawkish side". As such, we could see the tone of the ECB gradually adjusting to this dynamic, and thus becoming less and less dovish.

Chart 3: ECB's Policy Index To Move To Hawkish Side



Latin America Capital Flows

INTENSIFYING RISK-REPRICING & ASSET REALLOCATION IN THE REGION

- **Growth and interest rate differentials to affect capital flows to Latin America.**
- **Increased credit risk differentiation; intensified sovereign debt ratings activity.**
- **Market focus on systemically relevant economies: China and Mexico in focus.**
- **Exchange rate shifts to be aligned to macroeconomic fundamentals in 2017.**

The Latin American region continues its deep structural transformation, with the potential to attract steady foreign direct and portfolio investment flows in the year ahead. However, the anticipated gradual process of normalization of monetary policy in the USA to be conducted by the Federal Reserve (Fed) has already opened the gates for rigorous differentiation amongst asset classes and sovereign credits. We are of the view that the systemically relevant countries of the region are aptly prepared (through manageable systemic leverage, well-capitalized banking sectors, adequate access to international credit and strong international reserves positions) to withstand any disrupting shifts in Fed policy the year ahead. Nevertheless, international credit agencies have delivered a message of caution regarding the erosion in fiscal and debt metrics in selected cases; indeed, market-sensitive rating agencies still maintain a "negative" outlook on sovereign credit ratings of Brazil, Mexico and Colombia whereas a "stable" outlook is enjoyed by both Peru and Argentina.

The year ahead will see an improvement in growth dynamics within the Latin American economic landscape. Financial market trends have, over the past six months, anticipated an improving outlook for most countries in the region. It is worth highlighting that Brazil, the region's largest and world's 8th largest economy has been at the top of financial market performance charts in 2016. Indeed, the Brazilian real (BRL) has appreciated by 30% over the past 12 months alone whereas the benchmark equity market ibovespa index offered a 70% return in USD terms over the same period (please note that stock market capitalization in Brazil is the largest in the region and double that of Mexico, so it is used as a gauge of corporate market sentiment by dedicated emerging market investors). Although we do not expect a similar rate of market return in the coming year, the growth outlook is showing modest improvement with the likelihood of orderly currency adjustments in most cases. In a similar fashion, other countries in South America (Argentina, Peru and Chile) will also post accelerating growth dynamics, a factor of utmost relevance to long-term (not only portfolio) equity investors.

The normalization of monetary policy in some advanced economies, to be led by Fed policy shifts, will most likely have a strong influence in key countries more structurally connected with US business and monetary cycles such as Mexico. We are of the view that the corrective headwinds developing in Mexican currency (the peso depreciated by 18% against the USD over the last 12 months) and securities markets are more associated to shifting conditions in the North American credit cycle than the so-far speculative hypotheses of changes to regional trade policy. It

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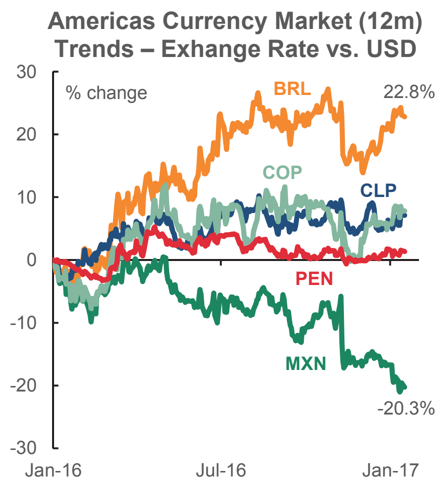
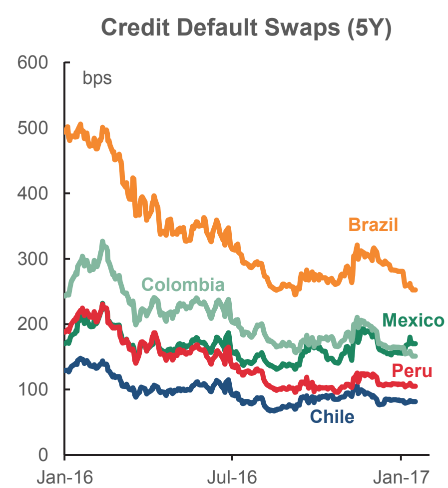
Chart 1



Sources: Scotiabank Economics, Bloomberg.

Chart 2



Sources: Scotiabank Economics, Bloomberg.

is worth highlighting that repatriation (out)flows from Mexico into the USA are a natural development of more normalized conditions in the North American monetary landscape as portrayed in the US treasury yield curve movements. Nevertheless, Mexico might still be subject to periods of investor overreaction and/or overshooting in the early months of the year until policy uncertainties at home and in the USA dissipate. Foreign holdings of Mexican (and Chinese) equity and debt securities will continue to decline in the year ahead.

China is and will continue to be a key influencing factor swaying capital flows in emerging-market economies. The combined negative effect of decelerating growth prospects and sizeable capital outflows (central bank reserves declined by nearly US$1 trillion between July 2014 and December 2016) also adds an element of complexity and uncertainty for investors and analysts dedicated to emerging markets. This is of particular systemic relevance as China has emerged as a key actor in sovereign and corporate credit markets in addition to its leading position in equity securities markets (China surpasses Japan as the top country in equity market capitalization in Asia, and it has become the single largest issuer of corporate bonds in the emerging market asset class). Both Moody's and Standard and Poor's have placed China's sovereign credit ratings (Aa3 and AA-, respectively) on review for a possible downgrade. Excessive leverage in the corporate bond space in addition to perceived credit allocation excesses in the real estate sector and the substantial loss of foreign exchange reserves are key issues at the core of investors' cautious behaviour.

Brazil

THE YEAR OF ECONOMIC RECOVERY AMIDST RIGOROUS ADJUSTMENT

- **Addressing fiscal emergency as key macroeconomic priority in 2017.**
- **Accelerated price stabilization fuels aggressive monetary easing.**
- **Economic revival & improved terms of trade leads to currency stability.**
- **Outstanding financial market performance will not be repeated this year.**

The Brazilian economy remains in strict fiscal adjustment mode. The implementation of budget restraint is critical to place the public finances back on sustainable ground. The latest data showed that the consolidated public sector deficit closed the year near 9% of GDP, impaired by a primary shortfall (excluding debt service) of 2.5% of GDP (see graph on fiscal trends). The administration of President Michel Temer continues to voice its commitment to introduce changes to the tax framework and pension legislation to gradually reduce the structural rigidities of labour markets and thereby instill business confidence. The government is fully aware of the need to accelerate fiscal restraint in an environment characterized by increasing costs of international finance. Looking ahead, an ambitious infrastructure development plan might attract sizeable foreign direct equity capital inflows in the next 2 years.

The central bank has succeeded in reversing inflationary expectations more rapidly than originally envisaged, paving the way for a growth-driven monetary policy normalization phase (inverse to the direction to be adopted by the US Federal Reserve). The 12-month consumer price inflation at near 6.5% (y/y) by the end of 2016 is fuelling expectations that the Brazilian Monetary Policy Committee (COPOM) might speed up the process of reference rate reductions throughout 2017. In fact, the quarterly inflation report published last December points towards continuous reductions in the central bank SELIC reference rate in the year ahead. It is worth highlighting that lower demand-side pressures from persistently weak economic activity coupled with increasing rates of unemployment will likely contribute to the process of disinflation under way and lower interest rates.

Brazil remains subject to a profound macroeconomic adjustment which is delaying a rapid recovery in economic activity. On the grounds of a deep industrial recession, skyrocketing unemployment (near 12%), severe government spending contraction and profound confidence crisis, real GDP is estimated to have declined by 3.5% y/y in 2016. Industrial production alone has contracted by 7% y/y last year. Nevertheless, business confidence indicators are showing modest signs of improvement and the external adjustment is proceeding successfully according to government targets. Indeed, the sharp compression in import activity as a result of the deep recession together with a mild recovery in exports has led to a steady narrowing of the current account deficit which closed last year at 1.1% of GDP down from 3.5% in 2015. The international trade surplus of US$50 billion is symptomatic of the deep adjustment undertaken in Brazil's external sector.

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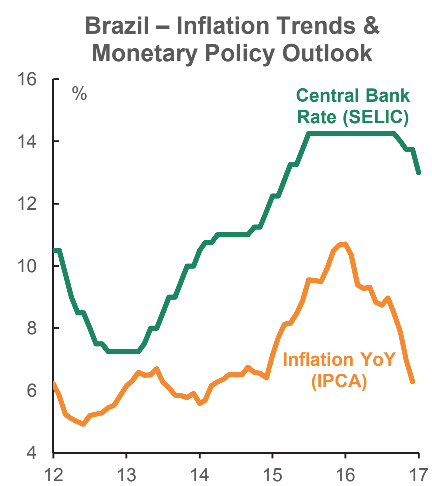
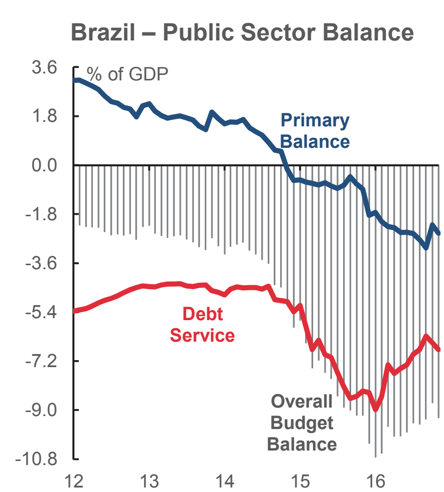
Chart 1



Sources: Scotiabank Economics, Bloomberg.

Chart 2



Sources: Scotiabank Economics, Bloomberg.

Brazil has offered hefty total returns to global portfolio investors over the past 12 months that will not be repeated in the year ahead. Following a sizeable currency devaluation, the Brazilian real (BRL) recovered some of the value lost during the overshooting phase, appreciating by 25% vis-à-vis the US dollar (USD) over the past 12 months. The powerful combination of high domestic interest rates and a recovering local currency also helped direct capital flows to the high-yielding Brazilian securities markets (both equity and debt assets). Indeed, the default insurance cost implied in credit default swap (CDS) contracts declined from 500 basis points (bps) in early January to 250 bps last December. The rebalancing of portfolios in emerging markets (out of Mexico and into Brazil) also contributed to the relative outperformance of Brazilian debt assets in 2016. Equity markets also experienced outstanding performance with the benchmark Ibovespa stock market index increasing by nearly 70% over the past 12 months. Despite the positive financial market tone embedded in the country's financial assets, all credit rating agencies downgraded Brazil's sovereign debt ratings in 2016, and all maintain a "Negative" outlook on their ratings. Looking ahead, we are of the view that Brazil will adapt smoothly to the changes in US trade, monetary and foreign policies, and that rating agencies may become gradually more optimistic (in line with market forces) about the country's creditworthiness.

Colombia

FISCAL & EXTERNAL ADJUSTMENTS FACILITATE DISINFLATION PATH

- **Energy price recovery supports FX stabilization & inflation control.**
- **Fiscal reform deepens structural transformation; rating agency moves.**
- **Slow economic recovery amidst tax reform & US monetary policy shifts.**
- **Complex socio-political environment following pacification accords.**

The Colombian economy remains influenced by global developments shaping the energy sector, particularly as oil prices remain a key driver affecting local currency market sentiment. The gradual, yet volatile, recovery in crude oil prices (up 100% in 12 months) has been a key driver of exchange rate stabilization and inflation control over the past few months (as can be seen in the right-hand graph). The recent accord by major oil producers on supply adjustments coupled with improving expectations on the global demand side has been a boon for the energy-linked Colombian peso (COP) which has stabilized and traded within a well-defined range over the past six months. Moreover, the deceleration in economic activity in the context of a stable exchange rate has been an additional driver of the process of disinflation. In fact, consumer price inflation has been trending downwards for the past four consecutive months; after peaking at a rate of 9% y/y in July 2016, headline inflation will likely converge to 4.5% by the end of 2017 (see graph on regional inflation trends). The prospect of improving inflationary expectations has led the central bank to take action and initiate the process of monetary policy normalization by reducing its reference rate by 25 bps to 7.5% last December. Looking ahead, we are aligned to the consensus of analysts and expect further rate cuts in the year ahead totaling 125 basis points.

The administration of President Juan Manuel Santos has advanced the process of structural reforms in order to diversify economic structures away from energy-sector fiscal dependence. The congressional approval of the structural fiscal reform last December is a major step forward to rebuild business confidence in the year ahead and a major development to be analyzed by international rating agencies. The increase of the VAT from 16% to 19% and the imposition of a uniform income tax rate of 32% are key components of the approved legislation. All credit agencies had placed Colombia's country ratings on "negative outlook" watch ahead of the tax reform bill. Looking ahead, implementation of the fiscal adjustment will be paramount to avoid a rating downgrade as the consolidated public sector deficit approaches 4% of GDP. The reduction of informality (estimated by the government at 50% of the labour force) is also of critical relevance to boost fiscal revenue in the years ahead. In this regard, the reform seeks to fight tax evasion in a more decisive manner.

The Colombian economy has closed the year 2016 on a weak note. On the grounds of still-fragile investment and consumption activity, real GDP growth has decelerated below 2% in 2016 and the recovery will only be modest in the year ahead. While it is true that the oil price recovery may have helped to anchor inflationary expectations, business and consumer confidence still need to

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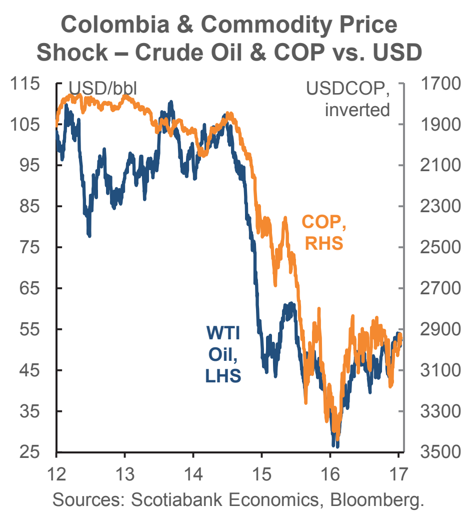

Sources: Scotiabank Economics, Bloomberg.

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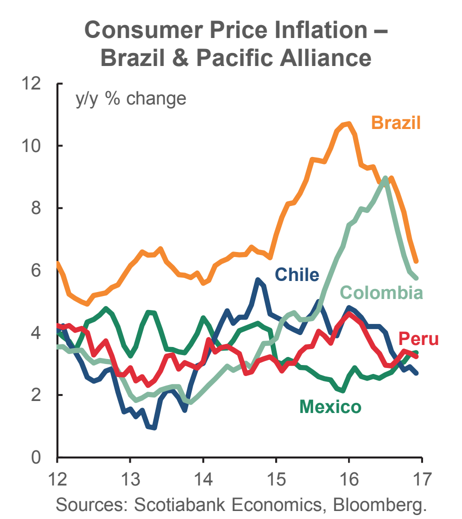

Sources: Scotiabank Economics, Bloomberg.

positively react to the major fiscal changes ahead. Looking ahead, the government's infrastructure programme (particularly in the road transport segment) will help attract long-term foreign capital investment in non-energy sectors. The normalization of monetary policy in the US and the associated increase in long-term interest rates and appreciation of the US dollar will also add external factors of relevance that will affect business confidence in the coming months. On a positive note, the ongoing contraction in import activity has contributed to gradually reduce the current account deficit estimated at 4.8% of GDP at present from 6.7% of GDP registered in 2015, a positive development that impacts exchange rate stabilization dynamics.

The administration of President Santos has received the congressional approval to the peace accords signed with the insurgent FARC group. Following the rejection by the population of the initial version of the peace accords in early October 2016, the recent congressional endorsement of the peace pacts is a positive development for the Colombian economy, particularly to speeding up the development of the agribusiness sector in geographic areas under control by the FARC group and its allies. Moreover, the recent passage of the tax reform highlights the ability of the current administration to advance the process of modernization and formalization of the Colombian economy.

Peru

TAKE A LOOK AT THE NEXT FIVE YEARS, NOT 2017

The starting point for 2017 growth is weak. The fourth quarter of 2016 was not a good one, with GDP growth likely to come in around 2.8% y/y, for the quarter. This compares to 4.2% for the first three quarters of 2016. However, the Kuzcynski administration should be judged on what happens in the next five years, not next five months. Nearly a semester into the Kuzcynski (PPK) administration, the sense we get is that the government is seriously involved in preparing the groundwork for robust growth in the medium-term and for the modernization of Peru's economy and institutions in the long-term. What is less evident is a sense of urgency concerning kick-starting domestic demand growth. Therefore, a return to strong domestic demand growth could be delayed until late 2017 or even 2018.

The bottom line is that the economy is entering 2017 with weak domestic demand, low public sector investment and negative construction growth. The question is how long into 2017 this situation will persist.

Recent monthly GDP data, 2.1% y/y growth for October and 3.6% in November is telling in its details. Slower mining production growth contributed somewhat to subpar growth, as most large copper projects came on stream a year ago or more. Mining sector contribution will continue declining going forward. However, a much more important factor was the sharp 15% y/y decline in central government spending in October. This was followed by a 9.5% decline in November, as the government has sought to bring the fiscal deficit below 3%, something which it accomplished, as the fiscal deficit closed the year at 2.7%. This fourth quarter fiscal policy highlights an administration with an unexpected preference for fiscal discipline over growth. At the same time, government measures to ease the approval process for regional and local government investment projects have led many of these governments to postpone investment plans until the new procedures are properly instituted.

Private sector investment continues declining, with little sign that it is nearing a point of inflection. While the business community continues to be aligned with the idea that this is the most favourable government for investment in recent memory, excess capacity in industries geared to domestic demand continues to prevent more aggressive investment plans.

The Central Bank has apparently decided to give economic growth a boost. In a surprise move, the CB lowered reserve requirements on both PEN (from 6.5% to 6.0%) and USD deposits (from 70% to 48%, a large decrease). This does not necessarily portend a lowering of the reference interest rate in the future, as inflation, which closed 2016 at 3.2%, is only marginally outside the CB target range. The CB has long argued that it uses the reference interest rate as an instrument to control inflation, whereas reserve requirements are the instrument used to stimulate growth.

Despite a slow beginning, there are a number of reasons to believe that the underlying economy (i.e., excluding mining) will pick up over time. For one, in 2017

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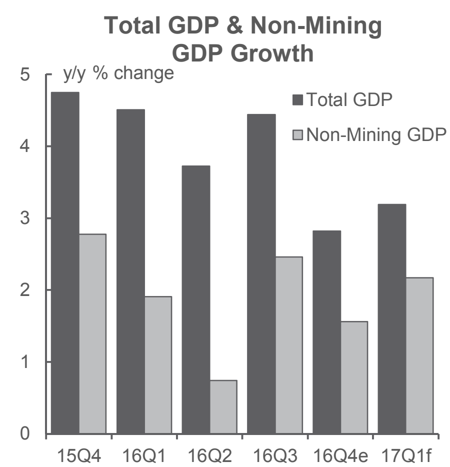

Sources: Research Department Scotiabank Perú, BCR.

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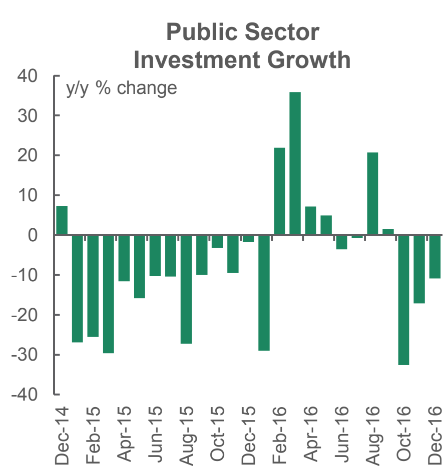
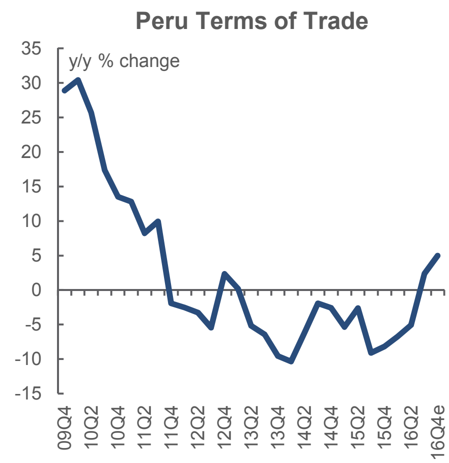


Sources: Research Department Scotiabank Perú, BCR.

government investment spending will normalize. This goal could conceivably be undercut by weak fiscal revenue growth at some point, in which case one wonders whether the government will allow the fiscal deficit to rise, or will once again curtail late-year spending to ensure achievement of their fiscal deficit target. A second is that progress has been made in freeing a number of PPP infrastructure projects from the red tape that has been holding them back. Spending on infrastructure projects should improve in 2017, and especially 2018. Additionally, terms of trade and exports should continue improving in 2017, as long as current metal prices continue to hold. Eventually, the historic association between terms of trade and growth should play out in 2017. Finally, investor expectations continue high, and typically translate into higher private investment, albeit with a lag.

The bottom line of the good and the bad is that we are lowering our growth forecast slightly, from 4.0% to 3.8%, considering a weaker-than-expected first quarter and uncertainty regarding the timing of a rebound in private investment. Note, however, that our new figures continue to constitute an improvement in non-mining GDP growth, from 1.6% in 2016 to 3.0% in 2017.

Chart 3



Sources: Research Department Scotiabank Perú, BCR, INEI.

Peru's markets have proven rather resilient to external risks. Neither the outcome of the US election nor the Federal Reserve rate increase have had a large negative impact on the PEN FX rate (which has remained stable or appreciated since both events) or on Peru global bond yields. This is a positive for Peru, given the impact FX volatility can have on domestic demand. Peru's FX rate ended 2016 at 3.35, a 1.7% appreciation for full-year 2016. This was in line with our expectations, but surprised the general market which expected a depreciation.

The fundamentals behind the PEN appreciation include a trade balance that has turned decidedly positive since mid-2016, on better terms of trade and higher copper output. This was expected, but the magnitude was greater than anticipated. For 2017, we expect a USD1.4 billion surplus, which will help bring the current account deficit down from its high of -4.4% of GDP in 2015, to closer to its historical norm at -3.0 % of GDP.

PEN fundamentals point to further appreciation in 2017, assuming a stable USD. However, the USD is not likely to be stable, and positive fundamentals will continue to vie with worldwide dollar strength in the PEN FX market. It's difficult to determine which will be the stronger of the two, and, as a result, we are assuming that the FX rate remains stable at 3.35. The risk is towards an appreciation.

Chile

ACTIVITY GROWTH RISK DOWNGRADED TO NEGATIVE FOR 2017

Finishing the year, our forecast of growth for the Chilean economy in 2016 had to be cut, reaching an annual rate close to 1.5%. Most of the year, economic activity was driven by services sectors and dampened by mining and manufacturing. The forecasts for 2017 remains centered at 2%. Although sectors profile should remain basically the same, we expect the dichotomy will be less extreme. Accelerated recovery could take place in the second half of the year due to both statistical and economic reasons. However, considering a long-term trend of 3%, growth will remain pretty subdued, with no signs of reaching that level before 2019, unless we see a dramatic change in terms of trade and domestic confidence. Risks to this forecast shifted from neutral to positive in October, but is negative now. Domestically, presidential and parliamentary elections are good reasons for investors to remain cautious, while worse-than-expected growth in last quarter of 2016 is not positive for mood and trend analysis weakened. The US election, though not necessarily negative for Chile, implies an additional risk for world trade. Data coming from China have remained supportive, but a riskier outlook is looming. Finally, risk rating for Chile might be entering in a wider negative outlook.

DEMAND WILL CRAWL

The unemployment rate continued relatively low in the current cycle, but most of this was possible due to a dramatic and persistent increase in self-employment. The phenomena should not continue forever. Accordingly, average unemployment rate in 2016 would be around 6.5%, but we expect an increase up to 7.1% in 2017. Nominal salary indexation is moderating. Given that part of the payroll is indexed to past inflation the weakness should prevail in coming quarters. This labour market will mean that private consumption is going to stay rather limited in coming quarters, as has been the case last three years. As for the investment outlook, we expect some positive shift in 2017, after the longest contraction period in decades. Most of this shy recovery will likely materialize by lower negative impact of mining investment, rather than by a strong rebound in other sectors. Of course, a critical improvement of the currently negative confidence conditions might give rise to a recovery of investment over the current year, being a rebuilding in inventories the first symptom of it. However, the opposite is a risk, too. Moreover, support coming from the fiscal policy will continue being limited because the low growth of the economy has reduced tax collection, just partially offset by the tax reform, and looming signals that this situation could worsen if the growth rhythm does not improve.

INFLATION ON TRACK, MONETARY POLICY WILL BE TWEAKED

Inflation continued receding, to 2,7% in 2016, three tenths below the centre of the target. Most of the inflation above the reference range (4%) in 2014 and 2015 was propelled by the exchange rate upsurge (more than 50% since April 2013 to December 2015). As this adjustment process seems to have been completed, the economy remains largely subdued, the exchange rate decreased almost 6% in 2016 and no major trend changes are expected for the current year, the inflation rate might decrease to 2.6%. This new condition gives some room for a more

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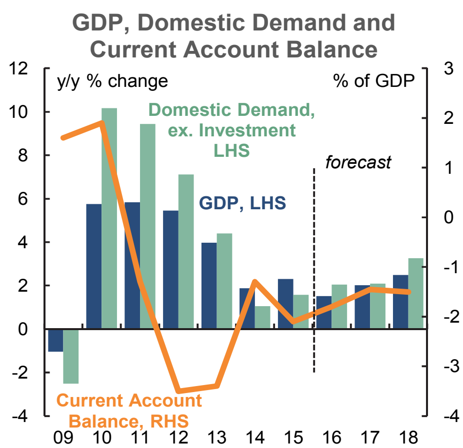
Chart 1



Source: Scotiabank Economics, INE, Banco Central de Chile.

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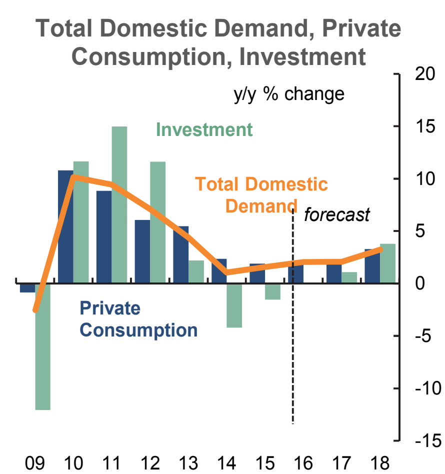


Source: Scotiabank Economics, INE, Banco Central de Chile.

expansive monetary policy, which should mean three cuts of 25bp each in the first quarter of the current year, to leave it at 2.75% for most of the year. Forecasts of monthly monetary policy should become more volatile from the second quarter onwards due to foreign and domestic factors. The goal of the of the monetary policy which is to keep the inflation close to 3%, most of the time has been met. Aligned with that, the short segment of the yield curve should decline in the first quarter. On the opposite, longest rates may benefit from a weak domestic economy, but volatility coming from the US long term yields and the exchange rate will keep them fluctuating in a rather wide range over most of the year.

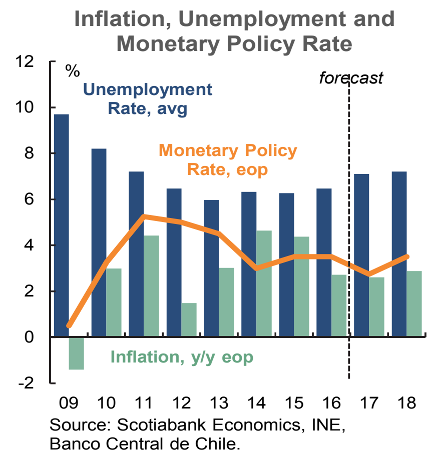
EXCHANGE RATE VOLATILE, BUT WITHIN A TRADE RANGE

The outlook for the exchange rate (CLP/USD) has not changed too much since October. On the copper side, the increase has been supporting an appreciation of the CLP, but the increasing value of the USD in international markets has compensated that change. This negative correlation between these two critical factors is not usual and has been surprising for some analysis, though pretty consistent with new expectations for world conditions. More surprising has been the low risk aversion reflected in market metrics. Accordingly, the most likely behavior continue being a trading range between 640 and 700. Although it may look wide, within this range, the exchange rate should be enough to keep export competitiveness and avoid inflationary pressures. Considering an average copper price of 241 (USc/lb) for the present year and 251 for the next, the current account deficit remains in a reasonable level of 1.5%, for both. Of course, a critical acceleration of expectation might cause a wider deficit, but not enough to be bigger than 3%.

POLITICAL STAGE MAY BECOME KEY… OR NOT!

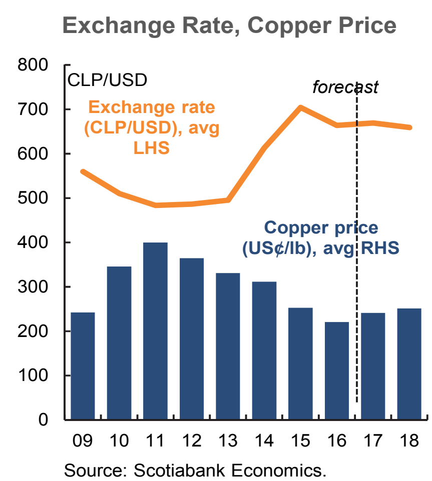
Due to the eroded political prestige, amidst an electoral period and deteriorated confidences (both investors' and customers') and low economic growth, new deep reforms, like that of the pension system, look harder to be accomplished in the current year. Besides, political support of the Government remains limited, especially in relation with its own coalition in the Congress. As said, the result of the municipal election, that took place in October, though positively construed at a first glance, hardly had a significant impact on confidence. Abstention was relatively high and prospects for President and Congress elections slated for next 19 November (the ballotage would take place on 17 December, which is very likely, under any scenario), are not now much more defined than the day before. A political turnaround toward more market friendly views could have a positive impact on business and consumer confidence, but if that does not happen in the first half of the year, the potential economic effect may vanish for the current year.

Chart 3



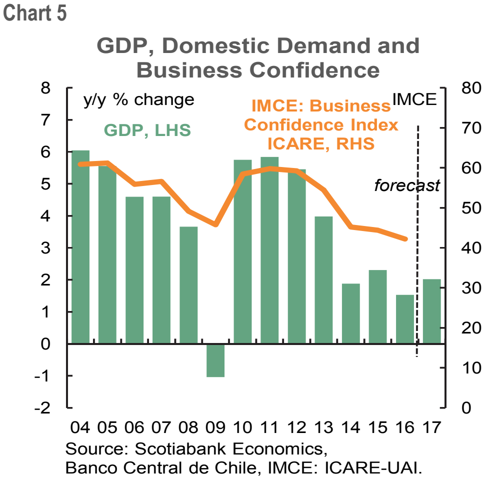
Source: Scotiabank Economics, INE, Banco Central de Chile.

Chart 4



Source: Scotiabank Economics.

Chart 5



Source: Scotiabank Economics, Banco Central de Chile, IMCE: ICARE-UAI.

China

2017—THE YEAR OF LEADERSHIP RESHUFFLE

- **Economic stability will be prioritized ahead of leadership changes.**
- **Increased protectionism abroad and persistent capital outflows are the key near-term risks to China's economic outlook.**
- **Longer-term outlook characterized by economic liberalization efforts.**

CHINA'S ECONOMIC TRANSITION CONTINUES

The maintenance of economic and financial stability will be the priority for Chinese policymakers in 2017 ahead of the 19th National Congress of the Communist Party of China at the end of this year, an important twice-a-decade gathering regarding the composition of the party leadership. The party congress, which will be held in the final quarter of 2017, will be an opportunity for President Xi Jinping to consolidate his power at the mid-point of his 10-year term that began in 2012. Up to five out of seven members of the Politburo Standing Committee—China's top policymaking body—are expected to retire this year due to the Communist Party's age limits, allowing President Xi to gather likeminded reformers around himself.

China's real GDP growth will continue to decelerate gradually on the back of ongoing economic transitioning. While Chinese authorities have recently emphasized stability over rapid economic growth, we assess that injections of fiscal stimulus in infrastructure will be continued, keeping the nation's output growth close to 6.5% in 2017. In addition to public outlays in infrastructure, momentum will be increasingly driven by the Chinese consumer and the services sector. Meanwhile, fixed capital investment and the industrial sector will continue to lose their importance as the key economic growth engines. Given the fading stimulatory impact of fiscal spending, China's real GDP growth will likely decelerate toward 6% in 2018.

Following the annual Central Economic Work Conference in mid-December 2016, Chinese authorities emphasized that in addition to a proactive fiscal policy, a prudent and neutral monetary policy will be maintained in 2017. Instead of making adjustments to the main policy tools, the People's Bank of China (PBoC) will likely continue to fine-tune monetary conditions with targeted policy measures. The central bank aims to maintain ample liquidity and curb asset bubbles given growing financial risks due to rising leverage. Banks' reserve requirement ratio has been kept at 17% since March 2016. The benchmark one-year loan and deposit rates of 4.35% and 1.50%, respectively, have been left unchanged since October 2015. We do not anticipate any changes to the policy rates over the coming months. While China's producer prices have ended their deflationary spell, the country's inflation outlook remains manageable. We expect consumer price inflation to remain below 3% y/y through 2018.

NEAR-TERM OUTLOOK

In our view, China's expected real GDP growth outperformance over the coming years will continue, allowing it to increase its global economic might. In the near-

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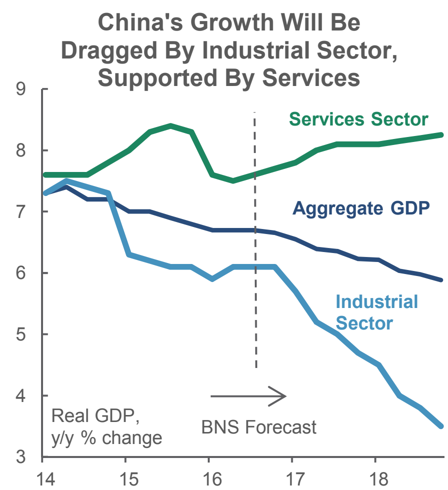
Chart 1



Sources: Scotiabank Economics, Bloomberg.

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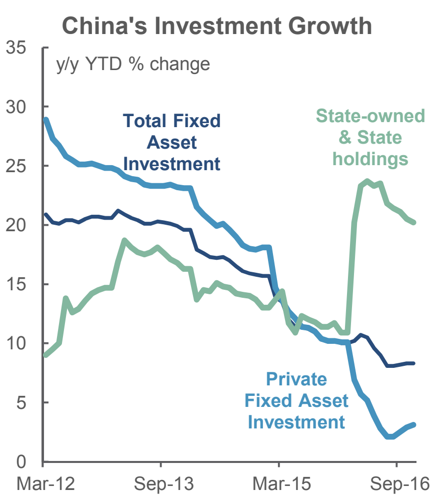

Sources: Scotiabank Economics, Bloomberg.

term, however, progress may be bumpy on the back of uncertainties stemming from the forthcoming Trump presidency in the US. The US is China's main trading partner, purchasing 20% of Chinese exports. Accordingly, any trade policy changes toward increased protectionism in the US, such as high tariffs on Chinese goods shipped to the US, would adversely impact China's economic growth prospects. Despite China's economic rebalancing toward a consumer-driven economy, the nation's exports still account for 21% of GDP. Indeed, they continue to be an important source of output growth while the economy reduces its reliance on credit-fueled investment.

Another near-term challenge for Chinese authorities is created by persistent weakening pressure on the Chinese yuan (CNY) against the US dollar (USD), which reflects sizeable capital flows out of China. The beginning of a new year brings along higher volatility due to the January 1st reset of Chinese citizens' annual US$50,000 foreign exchange purchase quotas. Given substantial growth in money supply in recent years, a limited number of attractive investment alternatives domestically, and expectations for continued currency depreciation, China's capital account is under increasing pressure as capital is seeking ways to leave the country in search of a higher yield. This has prompted the PBoC to intervene in the foreign exchange market to support the value of the CNY, which has resulted in a sizeable drop in China's foreign reserves. Additionally, the government has tightened existing capital controls by further restricting outbound foreign investment and individuals' foreign currency purchases. The PBoC also recently added 11 new currencies to the renminbi's currency basket, bringing the total to 24. Given the USD's reduced weight, the policy move should translate to less weakening pressure on the new basket. In our view, China's foreign reserves cannot drop much further without starting to trigger investor concerns regarding their sustainability; therefore, we assess that policymakers will increasingly rely on tighter capital controls over the coming months to limit the depreciatory pressure on the CNY. Nevertheless, as China will likely remain committed to further integration with the world economy and the internationalization of the renminbi, the recent restrictions on capital movement are expected to be temporary in nature.

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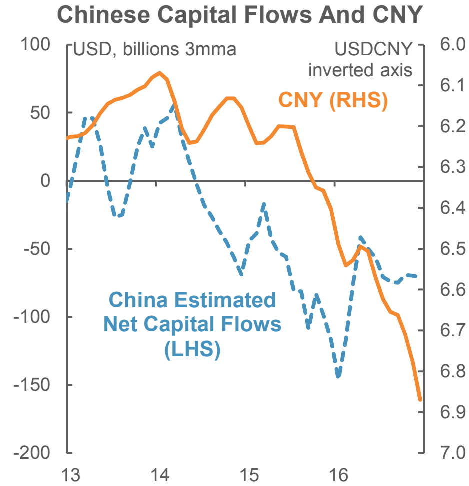

Sources: Scotiabank Economics, Bloomberg.

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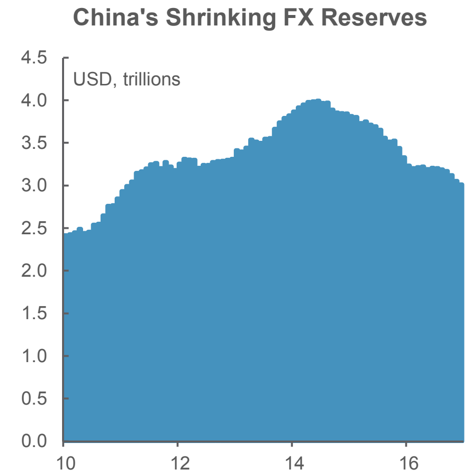

Sources: Scotiabank Economics, Bloomberg.

MEDIUM- AND LONG-TERM OUTLOOK

Despite near-term challenges, we expect the party congress at the end of this year to yield a leadership team that will remain fully committed to China's 13th Five Year Plan, an agenda of social and economic policies for 2016–2020 agreed at the end of 2015. The ambitious structural reform program is a roadmap for making China a "moderately prosperous society" by 2020.

We assess that the Chinese administration's reform efforts will be directed at the reduction of current economic imbalances, such as the persistent industrial overcapacity, excessive corporate leverage, and high housing inventory in some parts of the country. Addressing such pressing issues will result in slower economic growth but is necessary for China's longer-term prosperity. The Chinese leadership is also expected to further liberalize the economy by restructuring state-owned enterprises, promoting capital inflows, and reforming the financial system.

Reforming and liberalizing the economy gradually is critical for preventing a further build-up of economic imbalances and creating a more sustainable economic environment for the years to come. While we consider that implementation risks related to such significant structural reforms are elevated, we highlight that China enjoys substantial financial resources that can be employed if economic or financial stability is at risk. In addition, the country's centrally-planned system allows for efficient state intervention when needed. Therefore, we assess that China is well-equipped to continue to advance its economic liberalization platform cautiously and gradually, in line with former President Deng Xiaoping's guideline of "cross the river by feeling for stones".

Japan

LOW GROWTH, LOW INFLATION

- **Fiscal and monetary stimulus supports the economy in the short-term.**
- **Inflation will remain low despite ultra-loose monetary policy.**

ECONOMIC GROWTH OUTLOOK

The Japanese economy continues to struggle with structural impediments that hinder the nation's longer-term economic growth prospects. Over the foreseeable future, however, stimulative fiscal and monetary policies will help the economy to outperform its low potential growth of around ¼% y/y. We expect Japan's real GDP to expand by 0.6% y/y on average in 2017–18 following an advance of around 1% in 2016. While recent high-frequency indicators point to improved near-term momentum, Japan is set to remain in low-growth territory for years to come if policymakers fail to implement crucial economic reforms that would improve the economy's fundamentals for sustainable expansion.

In 2017–18, weak consumer confidence and a shrinking population will continue to dampen household spending prospects. Despite a tight labour market, wage growth continues to be negligible. Higher corporate profits, however, should translate to rising business investment over the coming quarters. While external demand uncertainties persist, a weaker Japanese yen is set to brighten the outlook for the country's exporters. The government 's draft budget for fiscal year 2017 (April-March) shows that fiscal policy will remain reflationary.

INFLATION AND MONETARY POLICY OUTLOOK

Japanese monetary authorities continue their fight against persistent deflationary pressures. Inflation (CPI, excl. fresh food) remains in negative territory with prices dropping by 0.4% y/y in November. Nevertheless, when food prices are included the headline measure bounced by 0.5% y/y. We do not anticipate the Bank of Japan's (BoJ) 2% y/y inflation target to be met in the foreseeable future given subdued wage growth and muted inflation expectations that reflect consumers' deflationary mindset. We expect headline inflation to hover at 1.0% y/y at the end of 2018.

The BoJ will likely leave monetary conditions unchanged over the coming months, given the yen's recent weakness and the fact that it has limited room for further easing. In September 2016, the central bank introduced a new monetary policy framework of "Quantitative and Qualitative Monetary Easing with Yield Curve Control", which has two key elements: "yield curve control" and "inflation-overshooting commitment". As per the former, the BoJ's guidelines for short- and long-term interest rates are -0.1% and around 0%, respectively. The BoJ's government bond purchases will be maintained at roughly ¥80 trillion annually, with short-term fluctuations allowed in order to facilitate necessary yield curve tweaking. The policy framework's inflation aspect emphasizes authorities' pledge to maintain accommodative policies in place until the 2% y/y inflation target is exceeded in a stable manner. Given such a promise, the BoJ's ultra-loose monetary policy stance is here to stay.

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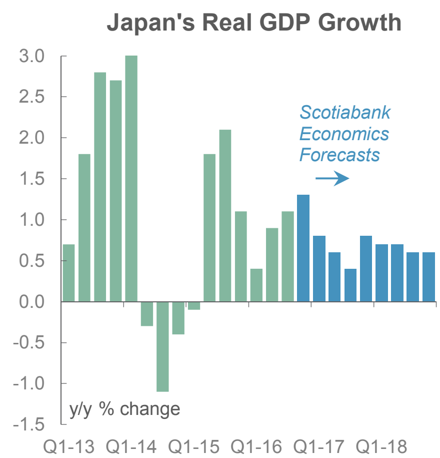
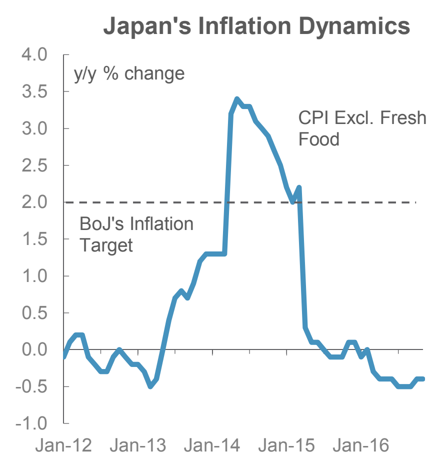
Chart 1



Sources: Scotiabank Economics, Bloomberg.

Chart 2



Sources: Scotiabank Economics Bloomberg.

India

WORLD'S FASTEST-GROWING MAJOR ECONOMY HITS SPEED BUMPS

- **A shortage of cash limits spending in a cash-based economy.**
- **Supportive policymaking underpins India's longer-term outlook.**

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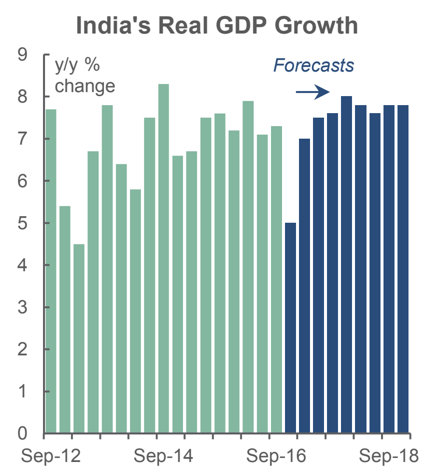
DEMONETIZATION DAMPENS INDIA'S NEAR-TERM GROWTH

The Indian economy is facing temporary headwinds, due to the government's demonetization efforts at the end of 2016. In early November, Prime Minister Narendra Modi announced that the Reserve Bank of India (RBI) would withdraw existing 500- and 1,000-rupee notes from circulation by the end of 2016. Authorities' intent was to shrink India's large informal economy. The process caused a cash shortage in the hands of Indian consumers due to the RBI's insufficient ability to print replacement notes. We estimate that this is causing a short-term adverse impact on household and business spending given the fact that India is primarily a cash economy. Indeed, high-frequency indicators point to weaker consumer and business sentiment and slower industrial activity since the policy announcement. In the medium-term, however, a higher deposit base in the banking system should translate to lower interest rates and higher lending, supporting economic growth.

Reflecting the demonetization drive's short-term impact on the economy, we have lowered India's real GDP growth forecasts for the final quarter of 2016 and the first quarter of 2017. We now estimate that the economy expanded by 6.8% in 2016 (compared with the prior forecast of 7.5%), with the pace likely picking up to 7.5% in 2017 (formerly 7.6%). Nonetheless, India will remain a growth outperformer among the world's major economies. Activity will continue to be underpinned by domestic demand that is responding to supportive policymaking and structural reforms. Nevertheless, India is expected to continue to struggle with a lack of private-sector investment until the nation's business environment improves further.

Chart 1



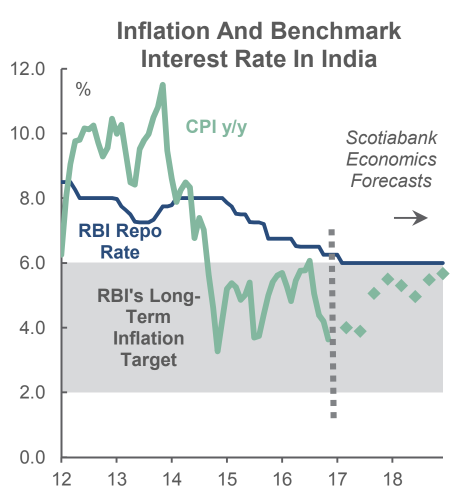
Sources: Scotiabank Economics, Bloomberg.

LOW INFLATION ALLOWS FOR FURTHER MONETARY STIMULUS

India's inflation environment remains favourable. The headline rate closed 2016 at 3.4% y/y and price gains are set to remain below the RBI's 5% target for March 2017. While price pressures will likely strengthen over the coming months on the back of a pick-up in energy costs and the forthcoming implementation of the Goods and Services Tax, we expect inflation to remain within the central bank's medium-term target of 4% ± 2% y/y through 2018.

Contained inflation and the adverse short-term impact on the economy caused by the demonetization efforts should allow the RBI to ease monetary conditions further in the near term. Nevertheless, an element of uncertainty to the monetary policy outlook is created by the forthcoming Union Budget presentation for the fiscal year 2017–18 (April-March). The new budget will be unveiled on February 1st. Assuming that the government's fiscal stance will remain prudent and non-inflationary even in the face of five approaching state elections in February and early March (Uttar Pradesh, Uttarakhand, Punjab, Manipur, and Goa), we expect the RBI to lower the benchmark repo and reverse repo rates by 25 bps to 6.0% and 5.50%, respectively, following the next monetary policy meeting on February 7th-8th.

Chart 2



Sources: Scotiabank Economics, Bloomberg.

Australia

COMMODITY GIANT IN THE MIDDLE OF ECONOMIC TRANSITION

- **Australia will remain a growth leader among advanced economies.**
- **Monetary policy will remain loose for an extended period of time.**

NEW SOURCES OF GROWTH NEEDED AFTER MINING INVESTMENT BOOM

The Australian economy is going through a structural adjustment, reflecting the end of a recent resource investment boom. Higher mining sector production capacity following investment project completions will continue to be reflected in increased export volumes. Given a recent pick-up in global commodities prices, Australia's terms of trade have started to improve since bottoming out in early 2016. Meanwhile, Australia's external outlook will remain dependent on Chinese demand as one-third of the nation's exports are shipped to China. Against this background, household spending and non-mining business investment will play key roles in future economic growth. Nevertheless, consumer spending prospects warrant close monitoring given that underemployment has increased and recent employment growth has been driven by part-time jobs.

In the third quarter of 2016, the economy surprised on the downside when real GDP expansion dipped to 1.8% y/y (-0.5% q/q non-annualized). We estimate that growth rebounded somewhat in the final quarter with the economy likely to have advanced by 2.4% in 2016 as a whole. Despite challenges, Australia will continue to be a growth leader among major advanced economies; with an expected output expansion of 2½% y/y in 2017–18, the nation will continue its respectable track record of uninterrupted real GDP growth over the past quarter of a century.

ACCOMMODATIVE MONETARY POLICY, CAUTIOUS FISCAL STANCE

Low interest rates will support domestic demand during the economy's structural change. The Reserve Bank of Australia (RBA) has left the benchmark interest rate unchanged at 1.50% since August 2016. Inflation is set to stay contained on the back of subdued wage gains and excess labour market capacity. The headline inflation rate will likely return to the lower end of the RBA's 2-3% y/y target over the coming quarters, reflecting global energy price moves. While the RBA's policymakers will continue to monitor labour market developments and any potential build-up of housing market imbalances, low inflation and continued need to support economic activity will likely prompt the central bank to ease monetary conditions further. We assess that the RBA will cut the benchmark rate one more time in this easing cycle, taking it to 1.25% in the first half of 2017.

Australian fiscal authorities face a dilemma—whether to support the economy or defend the "AAA" sovereign credit rating, which has has been under a "negative" outlook since July 2016. While Australia's public finances compare favourably with its peers and would allow for some growth-friendly spending, international credit rating agencies stress the need for new revenue or saving measures if the government aims to meet its target of a balanced budget by fiscal year 2020/21 (July-June). In our view, the economy's outlook could be significantly hampered by wrongly-timed fiscal consolidation efforts.

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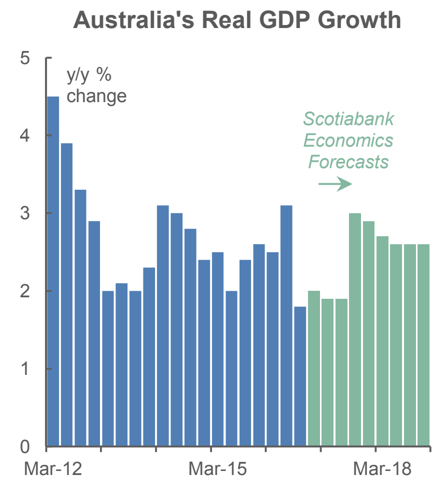
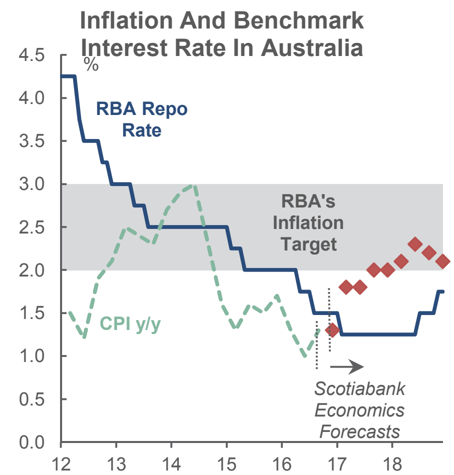
Chart 1



Sources: Scotiabank Economics, Bloomberg.

Chart 2



Sources: Scotiabank Economics, Bloomberg.

Commodities

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Commodities are expected to broadly benefit from rising prices in 2017 after many averaged cycle-lows last year. Oil will remain top-of-mind as OPEC output reductions are monitored and the market finally gets a taste of how quickly the US shale patch can put rigs and workers back to use as prices hover around $55 per barrel. Base metals are expected to gain from a more-buoyant global economy and rising manufacturing activity, with copper fundamentals in particular improving relative to our prior outlook. Meanwhile, the gold outlook has deteriorated slightly on the back of a stronger macro outlook, rising yields, and thus-far muted market response to political uncertainty.

ENERGY: OPEC FINALLY LENDS A HAND TO THE OIL RECOVERY

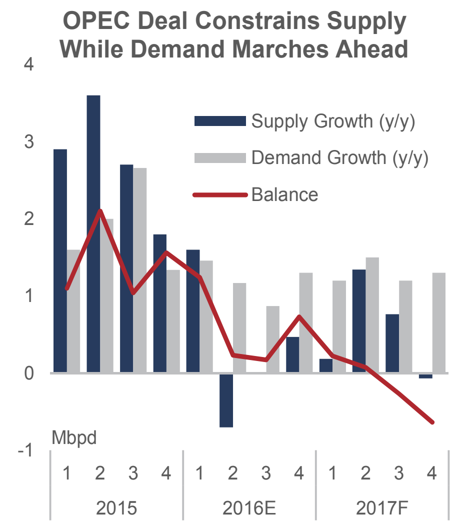
The oil market's recovery from the depths reached early last year, when WTI touched $26/bbl, remains on track and OPEC's recently-concluded deal to reduce output will artificially accelerate the rebalancing of supply and demand. **Prices for North American benchmark WTI have been moderately upgraded and are now forecast to average $58/bbl in 2017 and $61/bbl in 2018** .We see three key trends that will shape the oil market in 2017: 1) OPEC member compliance; 2) the strength and pace of the US shale patch's rebound; and 3) the persistence of global demand growth.

Our estimates indicate that global liquids supply was running at 97.7 Mbpd (+0.5 Mbpd y/y) against demand of 96.9 Mbpd (+1.3 y/y) in the final quarter of 2016. This 0.7 Mbpd surplus is down from 1.6 Mbpd the same time last year, and balances are expected to move to a deficit of 0.6 Mbpd by the final quarter of 2017. Supply growth is expected to remain depressed at 0.6 Mbpd in 2017, with demand advancing at roughly double that pace. Global inventories are forecast to begin drawing in the second half of 2017 (Chart 1), which will be the first sustained stock reduction since the beginning of 2014. Oil market balances are expected to average -0.2 Mbpd for 2017 as a whole.

We anticipate OPEC compliance of roughly 75%, with the strongest and clearest cuts coming from Saudi Arabia and its GCC allies, as well as a successful 6-month extension of the supply deal through the second half of the year. It appears that OPEC members are thus far going along with their committed cuts, with Saudi and core Gulf allies leading in rapid reductions as expected. OPEC members have a lot riding on this deal and a good amount of political capital has been spent to bring the disparate parties together, which is likely to improve member compliance relative to past OPEC deals which took place under more sanguine oil market conditions. However, the potential production resurgence of exempted members Libya and Nigeria, which are experiencing depressed production levels due to domestic conflict, could offset some of the deal's efficacy. Thus far, Libyan barrels are returning faster than expected while Nigerian supply has been further impacted by militant attacks on infrastructure, keeping their combined contribution roughly in line with base case expectations.

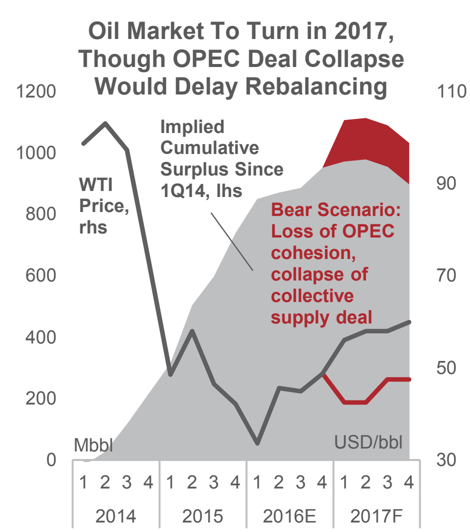
We also expect a moderate rebound of U.S. supply, which is expected to rise by 300–400 kbpd in 2017 as prices hover around $55/bbl WTI before rising toward $60/bbl by year-end. This will be our first real look at how the vast array of smaller

Chart 1



Sources: Scotiabank Economics, Scotiabank GBM, International Energy Agency.

Chart 2



Sources: Scotiabank Economics, Scotiabank GBM, International Energy Agency.

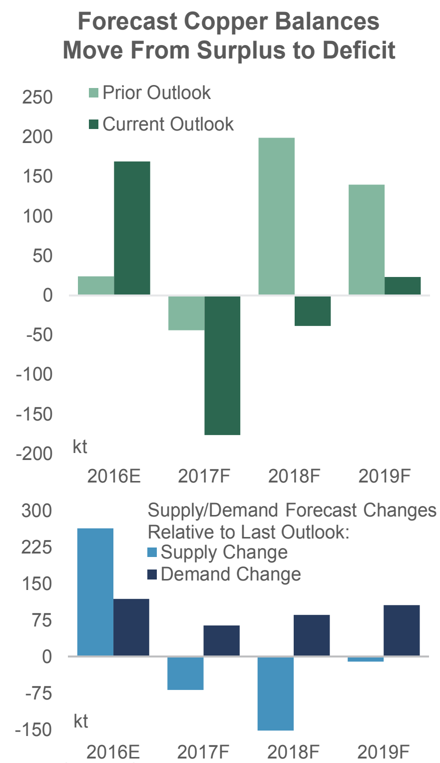
US shale producers can convincingly grow production, a development that will have a powerful anchoring effect on future price expectations. Industry costs have fallen considerably over the past 18 months since prices collapsed, with likely half of this due to organic efficiency improvements prompted by the lower-price reality. However, the balance of savings were obtained by pushing down service costs along the supply chain. As prices rise and the industry recovers, the demand for these service firms will increase. Rising service costs and the difficulty in getting workers back into the field are expected to limit the ability of the US. upstream to rapidly respond to the higher price environment.

METALS & MINERALS: IMPROVING COPPER FUNDAMENTALS PROMPT FORECAST UPGRADE

We have upgraded our price forecasts for all base metals in 2017 as fundamentals improve on the back of stronger global economic growth and rising manufacturing activity. Copper saw the most significant outlook adjustment, as stronger-than-anticipated Chinese demand runs up against weaker supply growth. Nickel prices were boosted in 2017 but downgraded in 2018 to account for the assumed ramp-up of domestic Indonesian nickel pig iron (NPI) capacity. Zinc remains the metal with the strongest supporting fundamentals, and the higher 2016 hand-off prompted an mild upgrade to price expectations.

Copper's fundamental outlook has improved since our last quarterly outlook, with stronger global demand running up against lowered production guidance through 2017–18 (Chart 3). Market balances for the red metal are expected to move into moderate deficit territory this year and next following six consecutive years of surplus. Copper prices rallied in the final months of 2016 from below $2.10/lb to $2.70/lb on a surge in speculative positioning before prices eased again as profits were taken. While we expected the rally to subside from its heights, **supportive details emerged through the quarter and we have increased our copper price forecast from $2.20/$2.20 to $2.40/$2.50 for 2017/18**. Speculative positioning has maintained record net length, but small gross length reductions indicate that some profit-taking has already occurred, which we expect to continue as market froth subsides and prices fall back into a sustainable $2.40-2.50/lb range.

Chart 3



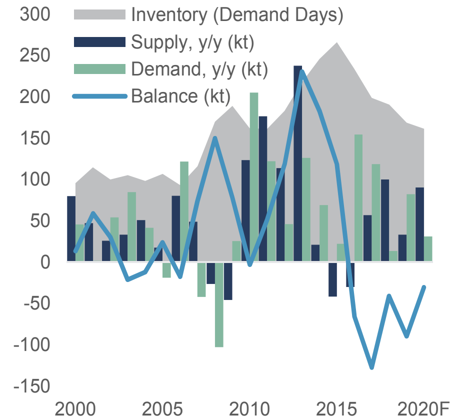
Sources: Scotiabank Economics, Wood Mackenzie.

Global copper demand is expected to average roughly 2% in 2017–18 after growth surprised on the upside last year. The largest demand changes have been seen in China, where the government's credit-stimulus and infrastructure push have bolstered the near-term outlook for Chinese copper consumption; moderately stronger global manufacturing indicators, both in developed and developing markets, are also constructive for global demand. China is expected to continue driving global demand growth over the coming years, with the more-rapid expansion of its electrical grid providing the strongest impetus. Chinese construction trends will be a drag on copper demand due to an anticipated fall-off in industrial building. Vehicle sales are expected to fall back in 2017 alongside the government's phase-out of the small-engine vehicle tax break, but the December 15th decision to extend part of the cut through 2017 will limit the downside.

Meanwhile, supply growth was strong in 2016 at 3.8% y/y and, despite an uptick in demand, the overall annual surplus is larger than previously expected (170kt vs 25 kt). Part of this supply strength was due to below-average mine disruptions, which were under 4% in 2016, despite some lost tonnage in the final quarters, relative to an average of above 5%. The low-price environment and sluggish economic activity have impacted the availability of copper scrap (down 9% y/y), which in turn boosted demand for freshly refined metal and offset some of the market slack that would have further swamped refined balances in 2016. However, the 2017–18 supply outlook has been downgraded: mine supply is expected to contract by roughly 0.5% y/y in 2017 vs a prior expectation of reasonable growth (+1.5%), with some of this due to more rapid ramp-ups this year—which brought forward supply into 2016—and some global producers shuttering higher-cost projects and offloading marginal assets in a quest to tackle an industry-wide debt overhang. Some major projects are expected to continue coming online over the forecast horizon and supply growth is expected to accelerate again in 2018 before the project pipeline slows considerably thereafter.

The nickel market has finally shifted to a sustainable deficit after a decade of surplus production added a million tonnes of refined metal to global inventories (Chart 4). These deficits are expected to be maintained over the next five years, though prices will only rise gradually as global stocks—which ended 2016 at nearly 270 days of demand relative to 100 day levels averaged over the decade preceding the run-up (1996–2006)—are worked down. **Prices are expected to continue rising in 2017 to average $5.20/lb, stumble slightly in 2018 to $5.00/lb** as Indonesia's nascent NPI industry begins production in earnest, and then continue rising through end-decade.

Chart 4



Sources: Scotiabank Economics, Wood Mackenzie.

Demand for nickel rose rapidly in 2016 and is expected to continue rising through 2017 as stainless steel capacity in China is ramped up, with global stainless melt forecast to grow 5% y/y in 2016–17. The key uncertainty that originally prompted an upturn in nickel prices, ahead of fundamental support, was the potential for significant nickel mine capacity shut-ins following environmental audits in the Philippines. Real supply impact has thus far been muted, but the continued delay in final decisions could keep the market spooked through the first half of the year. Chinese ore stocks—accumulated ahead of the seasonal monsoon-driven downturn in Filipino exports—will likely be depleted by the beginning of 2Q17, and global nickel supply could be hard hit if these smelters are unable to access fresh feedstock.

The zinc market remains acutely starved of concentrate following significant mine closures and price-prompted idling over the past two years, with global concentrate inventories falling to critically-low levels by the end of 2016. This tightness in concentrate stocks will limit the ability of smelters to respond to rising zinc prices, which will translate to accelerating price gains as refined inventories continue to draw and fall to around 35 days of demand by mid-2017 (relative to the 2006–2015 average of 78 days). **Zinc prices are forecast to average $1.35/lb in 2017 and $1.55/lb in 2018, continuing the already-impressive gains made over the course of 2016**. The key uncertainty for zinc remains how quickly Glencore restarts 500kt worth of mine capacity that was strategically idled in 2015-16. Our current assumption is that this tonnage will begin to return to the market in the latter half of 2017, though recent comments from Glencore leadership indicated that the ramp-ups could be slow (9-15 months per mine) and that restarts could be staggered. Any delay in this concentrate returning to market is expected to further exacerbate the trends currently pushing zinc prices higher and presents upside risk to our current forecast.

Gold's outlook has deteriorated since our last report, with prices now forecast to average $1,200/oz in 2017 and 2018 from $1,300/oz prior. The upgraded global economic outlook, rising inflation and interest rate expectations, and the thus-far muted market response to political events widely considered to stoke uncertainty all speak to gold's dimmer prospects. We are also closely tracking developments associated with India's demonetization push, which has the potential to negatively impact demand in the world's largest physical gold importer. However, we continue to believe that the market's sanguine view of the risk environment is slanted bullish, and that gold will find some support as these views revert to balance.

Table 1 — Commodities

	2000–2015			Annual Average		
	Low	Avg.	High	2016	2017f	2018f
WTI Oil (USD/bbl)	17	64	145	43	58	61
Brent Oil (USD/bbl)	18	67	146	45	60	63
Nymex Natural Gas (USD/mmbtu)	1.75	5.09	15.38	2.55	3.25	3.15
Copper (USD/lb)	0.60	2.36	4.60	2.21	2.40	2.50
Zinc (USD/lb)	0.33	0.81	2.10	0.95	1.35	1.55
Nickel (USD/lb)	2.00	7.45	24.58	4.36	5.20	5.00
Aluminium (USD/lb)	0.56	0.87	1.49	0.73	0.75	0.77
Iron Ore (USD/tonne)	17	68	187	58	55	50
Metallurgical Coal (USD/tonne)	39	127	330	115	180	120
Gold, London PM Fix (USD/oz)	256	845	1,895	1,251	1,200	1,200

Foreign Exchange

US DOLLAR STRENGTH TO PERSIST INTO 2017

We remain bullish on the US dollar (USD) and expect the greenback's winning run to extend well into 2017. Much of the USD's strength in the last few years was predicated on the idea that it represented the "least dirty shirt" among a group of advanced economy currencies that all had their own challenges. However, markets are anticipating that the Trump presidency will be characterised by pro-business, pro-growth policies which deliver above-trend GDP, higher inflation and stronger corporate profitability to the US economy. This will underpin the Federal Reserve's (Fed) gradual tightening of monetary policy and suggests quite strongly that the USD rally can stand—and extend—on its own merits though H1 2017, at which point we expect gains to moderate.

While it remains too early to know precisely what the incoming administration intends to do—and when it will be able to practically implement policies—there is a clear expectation that tax cuts, fiscal spending and deregulation will form a significant part of the Trump agenda. Moreover, the new administration may implement corporate tax policies which favour exports whilst penalising imports and support a time-limited repatriation of US corporate profits accumulated and held offshore. These initiatives may provide additional support to the USD.

For the moment, the potential positives are overshadowing the potential risks (the adverse impact of protectionism and trade frictions, wider fiscal deficits) that the Trump administration holds for the USD. And if the USD looks strong, it does not appear over-valued. The USD's recent gains appear well-supported by the US economy's growth advantage as well as wide (and widening) short-term interest rate differentials versus its major currency peers. Markets are still not quite fully pricing in the three additional rate increases Scotiabank (and the Fed) anticipate for the coming year. However, confidence in the US growth outlook will bolster expectations that the Fed will tighten policy, supporting USD gains.

The Canadian dollar (CAD) held up relatively well against the surging USD in Q4 2016 and while we expect it to remain firm versus its G-10 peers in the next few months, we think the CAD will struggle to keep pace with the rising USD, even with commodity prices (and oil in particular) trading on a firmer footing. The problem for the CAD is that the domestic economic outlook remains challenged by soft, non-commodity exports and weak business investment. As Trump's election campaign focused on trade and border issues, his win appears to have prompted a surge in Canadian worries about the economic (policy) outlook which may hamper a recovery in either exports or capital spending.

The CAD's relative strength on the crosses has delivered a roughly 4% rise in the CAD's effective exchange rate over the past year while higher US interest rates are also pulling up longer-term rates in Canada. Both of these factors are delivering an inappropriate tightening in domestic monetary conditions, considering slow growth and declining inflationary pressures. We expect the Bank of Canada to maintain a highly accommodative stance throughout 2017 while the Fed tightens. The wider yield differential between short-term rates in the US and Canada will likely lift USDCAD to 1.40 through mid-year.

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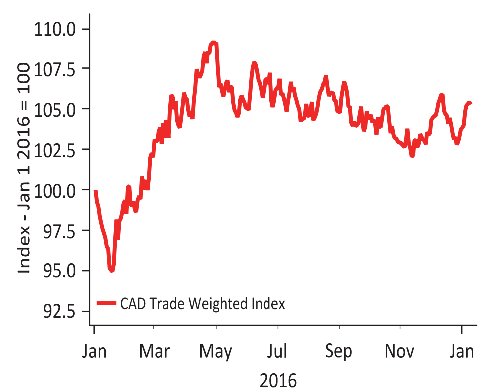
Chart 1

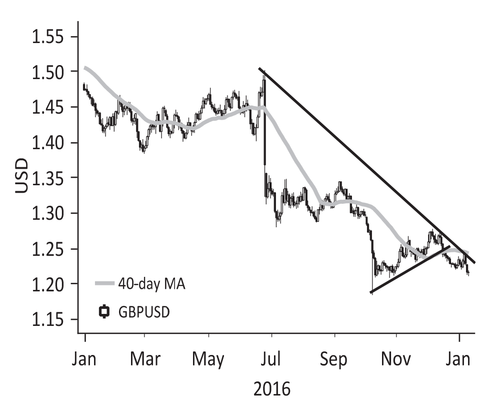
CAD Appreciates Broadly Since Jan 2016



Source: Macrobond, Scotiabank FX Strategy

Chart 2

GBPUSD Bear Trend Intact



Source: Macrobond, Scotiabank FX Strategy

European currencies are still dealing with the aftermath of the UK's Brexit referendum decision last June. The UK government is expected to invoke Article 50, which will formally launch exit proceedings, by the end of March. The UK economy held up remarkably well in H2 2016, prompting the Bank of England to adopt a neutral policy bias. We continue to feel that the pound (GBP) is vulnerable to growth disappointment and uncertainty surrounding the EU exit process, however, and forecast GBPUSD reaching 1.20 in the next few months.

Meanwhile, the strong USD and the European Central Bank's decision to extend its quantitative easing until September 2017 (albeit at a slightly lower rate of monthly asset purchases) combined to push the euro (EUR) to its lowest level since 2003 in early January. We expect EURUSD to remain under pressure in the months ahead as investors focus on diverging growth and monetary policy trends between the USA and the Eurozone. Political focus suggests that more persistent EUR weakness (or a potential push below par) are non-negligible risks for EURUSD around the French presidential election (first round 23rd April) or the German general election (September). As the risk of UK shocks may recede after March while Eurozone risk may increase, we think EURGBP is liable to ease somewhat in the coming months.

The Japanese yen (JPY) was the worst-performing G-10 currency in Q4, reflecting rising US interest rates and wider US-Japan rate differentials at the long-end of the curve as well as JPY under-performance in a generally pro-risk environment as US equity markets rose following the election. Slowing Chinese growth and the risk of heightened Sino-US tensions have also weighed on regional FX sentiment and risks spilling over into the Australian and New Zealand dollars (AUD and NZD, respectively), given China's sourcing of commodities from the region. The AUD and NZD are both trading at relatively "rich" levels versus the CAD from an historic perspective and may under-perform moving into 2017.

Regional Asia FX will continue to be primarily driven by US fundamentals, monetary policy prospects and the President-elect's economic and fiscal policies. Seasonal trends, which typically see the USD advance in Q1 and slide in April may remain intact this year.

The downward pressure on the Chinese yuan (CNY) will extend into 2017. The People's Bank of China will try and curb escalating one-way expectations of yuan depreciation on the one hand whilst preparing for future yuan depreciation on the other in the months ahead. Offshore yuan liquidity conditions are likely to ease somewhat but remain relatively tight ahead of Chinese New Year to deter speculative pressure on the CNY.

India's onshore cash liquidity conditions have improved markedly. With about 80-90% of outlawed notes expected to be replaced by the end of February, the nation's interbank funding costs are likely to start rising. Moreover, the BJP-led NDA government's ability to push forward reforms that are positive for the Indian rupee (INR) will be enhanced if the party can win Assembly elections in five states with results due 11 March.

The Korean won (KRW), the Malaysian ringgit (MYR) and the Singapore dollar (SGD) remain the most vulnerable currencies to Fed rate hikes this year. Meanwhile, we remain cautious on the risk of the Indonesian rupiah (IDR) being squeezed lower given high foreign ownership of local government bonds. The Taiwanese dollar (TWD) is likely to suffer from cross-strait tensions emerging under the new Trump administration, while the Thai baht (THB) will continue to trade along with regional peers in the months ahead.

LATAM FX's performance over the past few weeks has been quite differentiated, with the Brazilian real outperforming (+6.0% in the past month), while Mexican peso (MXN) lags all other regional currencies (-1.6%). The story in Brazil remains one of investors thinking the economy has bottomed, and there is some upside on structural reforms while, for Mexico, the main source of pressure has been uncertainty over the future of US policy, particularly with regard to trade and investment.

Based on real effective exchange rate, the MXN is now the weakest currency among the 24 emerging market currencies tracked by Bloomberg (almost 3 standard deviations cheap). However, the uncertainty surrounding President Trump's policies towards Mexico is not expected to dissipate before the summer, likely leaving the peso under pressure, or at least volatile.

Among the Andeans, the Colombian peso—arguably the region's most oil-dependent currency among the liquid currencies—is likely to see its fortunes dictated by oil price dynamics. The Chilean peso should continue trading sideways as it has done since June. The central bank remains on hold, but we don't discount the start of an easing cycle, as inflation dynamics turn favourable, while growth remains quite lacklustre.

The Peruvian sol (PEN) has been slowly but surely appreciating and our sense from looking at client flow is that interest in local bonds is rising—even if their nominal yields are not particularly compelling. Strong growth and a solid balance sheet make the PEN a safe-haven of sorts. The Institute of International Finance reported that capital outflows from emerging markets in 2016 were the worst since 2008. Our sense is that the PEN may reflect Peru being one of the few spots where appetite for exposure seems to be improving.

APPENDIX 1

International	2000–15	2016e	2017f	2018f	2000–15	2016e	2017f	2018f
	Real GDP (annual % change)				Consumer Prices (y/y % change, year-end)			
World (based on purchasing power parity)	3.9	3.0	3.4	3.4				
Canada	2.2	1.4	2.0	2.0	1.9	1.3	2.2	2.1
United States	1.9	1.6	2.3	2.4	2.2	1.7	2.4	2.3
Mexico	2.4	2.1	1.5	2.1	4.5	3.4	5.5	4.3
United Kingdom	1.8	2.1	1.6	1.2	2.2	1.1	2.8	2.2
Euro zone	1.2	1.6	1.7	1.7	1.9	1.1	1.4	1.7
Germany	1.2	1.7	1.8	1.7	1.6	1.7	1.5	1.8
France	1.3	1.2	1.4	1.6	1.7	0.6	1.3	1.4
Russia	4.6	-0.6	1.2	1.4	11.4	7.1	5.5	5.0
China	9.8	6.7	6.4	6.0	2.4	2.1	2.4	2.5
India	7.0	6.8	7.5	7.8	7.2	3.4	5.5	5.7
Japan	0.9	0.9	0.7	0.6	0.0	0.5	0.7	1.0
South Korea	4.4	2.7	2.5	2.6	2.8	1.3	1.8	2.3
Indonesia	5.6	5.0	5.3	5.5	6.2	3.0	4.4	4.7
Australia	3.0	2.4	2.4	2.6	2.9	1.3	2.0	2.1
Thailand	4.1	3.2	3.2	3.1	2.5	1.1	1.9	2.2
Brazil	3.4	-3.5	0.5	2.0	6.5	6.3	5.0	4.5
Colombia	4.2	1.9	2.4	3.3	5.0	6.5	4.5	4.0
Peru	5.3	3.8	3.8	4.2	2.7	3.2	3.1	2.8
Chile	4.3	1.5	2.0	2.5	3.3	2.7	2.6	3.0
Commodities								
	(annual average)							
WTI Oil (USD/bbl)	64	43	58	61				
Brent Oil (USD/bbl)	67	45	60	63				
Nymex Natural Gas (USD/mmbtu)	5.09	2.55	3.25	3.15				
Copper (USD/lb)	2.36	2.21	2.40	2.50				
Zinc (USD/lb)	0.81	0.95	1.35	1.55				
Nickel (USD/lb)	7.45	4.36	5.20	5.00				
Aluminium (USD/lb)	0.87	0.73	0.75	0.77				
Iron Ore (USD/tonne)	68	58	55	50				
Metallurgical Coal (USD/tonne)	127	115	180	120				
Gold, London PM Fix (USD/oz)	845	1,251	1,200	1,200				

APPENDIX 2

North America	2000–15	2016e	2017f	2018f	2000–15	2016e	2017f	2018f
	Canada (annual % change)				United States (annual % change)			
Real GDP	2.2	1.4	2.0	2.0	1.9	1.6	2.3	2.4
Consumer Spending	2.9	2.2	2.0	1.7	2.3	2.7	2.7	2.6
Residential Investment	3.8	2.3	-1.8	-0.8	-0.7	4.8	2.7	2.7
Business Investment	2.7	-6.8	0.0	2.9	2.4	-0.5	2.1	3.2
Government	2.2	1.8	2.1	1.5	1.0	0.8	0.9	1.2
Exports	1.3	1.0	2.3	4.0	3.8	0.5	2.1	2.8
Imports	3.1	-0.8	1.3	3.0	3.5	0.8	3.0	3.5
Nominal GDP	4.4	2.1	4.3	4.0	4.0	3.0	4.3	4.4
GDP Deflator	2.2	0.7	2.3	2.0	2.0	1.3	2.0	2.0
Consumer Price Index	2.0	1.4	2.1	2.0	2.2	1.3	2.5	2.3
Core CPI	1.8	1.9	1.7	1.9	2.0	2.2	2.2	2.3
Pre-Tax Corporate Profits	3.9	-5.0	9.0	4.0	5.9	-0.5	5.0	3.0
Employment	1.4	0.7	1.1	0.8	0.6	1.7	1.4	1.3
Unemployment Rate (%)	7.1	7.0	6.9	6.8	6.3	4.9	4.6	4.5
Current Account Balance (CAD, USD bn)	-13.9	-69.3	-55.0	-43.0	-521	-484	-513	-545
Merchandise Trade Balance (CAD, USD bn)	28.2	-31.1	-17.5	-8.5	-668	-735	-774	-825
Federal Budget Balance (FY, CAD, USD bn)	-2.9	-1.0	-27.0	-32.0	-529	-587	-610	-650
per cent of GDP	-0.2	0.0	-1.3	-1.5	-3.8	-3.2	-3.1	-3.2
Housing Starts (000s, mn)	199	198	190	185	1.27	1.17	1.26	1.34
Motor Vehicle Sales (000s, mn)	1,639	1,949	1,940	1,925	15.4	17.5	17.8	17.9
Industrial Production	0.5	-0.7	2.0	1.6	0.8	-1.0	1.5	2.0
	Mexico (annual % change)							
Real GDP	2.4	2.1	1.5	2.1				
Consumer Price Index (year-end)	4.5	3.4	5.5	4.3				
Current Account Balance (USD bn)	-15.8	-29.3	-22.0	-25.4				
Merchandise Trade Balance (USD bn)	-6.8	-15.8	0.2	1.2				

Quarterly Forecasts	2016				2017				2018			
Canada	Q1	Q2	Q3	Q4e	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Real GDP (q/q, ann. % change)	2.7	-1.3	3.5	2.5	1.8	2.2	2.0	2.0	2.0	1.9	1.9	1.9
Real GDP (y/y, % change)	1.3	1.1	1.3	1.8	1.6	2.5	2.1	2.0	2.0	2.0	1.9	1.9
Consumer Prices (y/y, % change)	1.5	1.6	1.2	1.3	1.9	1.9	2.3	2.2	2.0	2.0	2.1	2.1
Core CPI (y/y % change)	2.0	2.1	1.9	1.7	1.7	1.7	1.8	1.8	1.9	1.9	1.9	1.9
United States												
Real GDP (q/q, ann. % change)	0.8	1.4	3.5	2.2	2.0	2.1	2.3	2.3	2.5	2.5	2.3	2.4
Real GDP (y/y, % change)	1.6	1.3	1.7	2.0	2.3	2.5	2.1	2.2	2.3	2.4	2.4	2.4
Consumer Prices (y/y, % change)	1.1	1.1	1.0	1.7	2.6	2.5	2.7	2.4	2.3	2.3	2.4	2.3
Core CPI (y/y % change)	2.3	2.2	2.2	2.1	2.1	2.1	2.2	2.3	2.3	2.3	2.3	2.3

APPENDIX 3

	2016		2017				2018			
Central Bank Rates	**Q3**	**Q4**	**Q1f**	**Q2f**	**Q3f**	**Q4f**	**Q1f**	**Q2f**	**Q3f**	**Q4f**
Americas				(%, end of period)						
Bank of Canada	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.75	0.75	1.00
U.S. Federal Reserve	0.50	0.75	0.75	1.00	1.25	1.50	1.50	1.75	1.75	2.00
Bank of Mexico	4.75	5.75	6.25	6.75	7.00	7.25	7.50	7.50	7.50	7.50
Central Bank of Brazil	14.25	13.75	12.50	11.25	10.50	10.00	9.75	9.50	9.50	9.00
Bank of the Republic of Colombia	7.75	7.50	7.00	6.75	6.50	6.25	6.00	6.00	6.00	6.00
Central Reserve Bank of Peru	4.25	4.25	4.25	4.25	4.25	4.25	4.25	4.25	4.25	4.25
Central Bank of Chile	3.50	3.50	2.75	2.75	2.75	2.75	2.75	3.00	3.25	3.50
Europe										
European Central Bank	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Bank of England	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
Swiss National Bank	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75
Asia/Oceania										
Reserve Bank of Australia	1.50	1.50	1.25	1.25	1.25	1.25	1.25	1.25	1.50	1.75
Bank of Japan	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10
People's Bank of China	4.35	4.35	4.35	4.35	4.35	4.35	4.35	4.35	4.35	4.35
Reserve Bank of India	6.50	6.25	6.00	6.00	6.00	6.00	6.00	6.00	6.00	6.00
Bank of Korea	1.25	1.25	1.25	1.25	1.25	1.25	1.25	1.50	1.50	1.75
Bank Indonesia	5.00	4.75	4.75	4.75	4.75	4.75	4.75	5.00	5.00	5.25
Bank of Thailand	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.75	1.75	2.00
Currencies & Interest Rates										
Americas				(end of period)						
Canadian Dollar (USDCAD)	1.31	1.34	1.38	1.40	1.38	1.36	1.36	1.34	1.32	1.30
Canadian Dollar (CADUSD)	0.76	0.74	0.72	0.71	0.72	0.74	0.74	0.75	0.76	0.77
Mexican Peso (USDMXN)	19.39	20.73	21.63	21.59	21.83	22.25	22.49	22.31	22.39	22.69
Brazilian Real (USDBRL)	3.26	3.26	3.50	3.50	3.55	3.55	3.50	3.50	3.60	3.75
Colombian Peso (USDCOP)	2882	3002	3000	3100	3125	3175	3175	3200	3175	3150
Peruvian Nuevo Sol (USDPEN)	3.38	3.36	3.43	3.40	3.43	3.35	3.23	3.22	3.20	3.19
Chilean Peso (USDCLP)	657	670	666	667	668	669	667	664	661	659
Europe										
Euro (EURUSD)	1.12	1.05	1.02	1.02	1.05	1.10	1.12	1.12	1.15	1.15
U.K. Pound (GBPUSD)	1.30	1.23	1.20	1.20	1.25	1.25	1.30	1.30	1.35	1.35
Swiss Franc (USDCHF)	0.97	1.02	1.09	1.09	1.07	1.02	1.00	1.00	0.97	0.98
Swedish Krona (USDSEK)	8.58	9.10	9.00	8.90	8.80	8.70	8.60	8.50	8.40	8.30
Norwegian Krone (USDNOK)	7.98	8.64	8.20	8.20	8.00	8.00	7.80	7.60	7.40	7.20
Russian Ruble (USDRUB)	62.9	61.5	64.0	63.5	63.5	63.0	63.0	62.5	62.5	62.0
Asia/Oceania										
Japanese Yen (USDJPY)	101	117	115	115	117	117	121	121	122	122
Australian Dollar (AUDUSD)	0.77	0.72	0.76	0.76	0.75	0.75	0.75	0.75	0.78	0.78
Chinese Yuan (USDCNY)	6.67	6.95	7.00	7.20	7.20	7.30	7.30	7.35	7.35	7.40
Indian Rupee (USDINR)	66.6	67.9	68.5	69.0	69.0	69.5	69.0	68.5	68.5	68.0
South Korean Won (USDKRW)	1101	1208	1220	1240	1240	1260	1240	1220	1220	1200
Indonesian Rupiah (USDIDR)	13042	13473	13500	13800	13800	14000	13800	13600	13600	13500
Thai Baht (USDTHB)	34.6	35.8	36.0	36.5	36.5	37.0	36.5	36.0	36.0	35.5
Canada (Yields, %)										
3-month T-bill	0.53	0.46	0.50	0.50	0.50	0.50	0.60	0.80	0.90	1.10
2-year Canada	0.52	0.75	0.75	0.85	0.95	1.05	1.20	1.35	1.45	1.60
5-year Canada	0.62	1.11	1.15	1.25	1.30	1.40	1.50	1.65	1.80	1.90
10-year Canada	1.00	1.72	1.75	1.80	1.85	1.90	1.95	2.10	2.20	2.35
30-year Canada	1.66	2.31	2.35	2.30	2.35	2.45	2.55	2.65	2.75	2.80
United States (Yields, %)										
3-month T-bill	0.27	0.50	0.55	0.80	1.05	1.25	1.30	1.55	1.60	1.80
2-year Treasury	0.76	1.19	1.25	1.40	1.50	1.70	1.75	1.90	1.95	2.10
5-year Treasury	1.15	1.93	2.00	2.10	2.20	2.30	2.40	2.50	2.55	2.60
10-year Treasury	1.59	2.44	2.50	2.60	2.70	2.80	2.85	2.90	2.95	3.00
30-year Treasury	2.31	3.07	3.05	3.15	3.20	3.30	3.35	3.40	3.45	3.50

Fixed Income Strategy (London, Paris)

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Foreign Exchange Strategy