Peak Growth

- **The synchronized expansion in the global economy continues, leading to mutually reinforcing growth that cuts across geographies and sectors.**
- **The robust global setting is providing a strong backdrop to Canadian growth, even though NAFTA and other risks weigh on the outlook. Growth in Canada will likely slow to 2.3% in 2018, but remain well above potential, adding to inflation pressures and requiring further tightening by the Bank of Canada. Three rate hikes are forecast in 2018, with the next expected on January 17.**
- **The Federal Reserve will raise rates by 75 bps as well. With reasonably stable oil prices, this should leave the Canadian dollar hovering around the 80 cent range for most of the year.**
- **Risks loom large, but the strength in global activity is a powerful tonic against trade-related uncertainties.**

The global economy continues to impress. Household spending and business activity are accelerating or remain strong in most of the economies we track. Measures of confidence and/or activity are at cycle highs in many countries (chart 1). With still extremely accommodative monetary policies in much of the advanced world, this is contributing to a powerful positive feedback loop amongst economies. Against this backdrop of synchronized growth, wage and inflation developments continue to diverge. In Canada, the United States and the United Kingdom, wage and/or inflation dynamics require a continued withdrawal of monetary stimulus while, in Europe and Japan, inflation remains stubbornly low with little sign of acceleration. These divergent paths for inflation imply that policy will tighten further in countries with rising inflation, but the extent to which these moves in short-term rates are translated up the yield curve risks being capped by ongoing quantitative easing programs in Europe and Japan. All this is occurring in an environment of heightened geopolitical concerns (the fear of developments in North Korea), trade and political developments in the United States, worries about equity market valuations and more generalized concerns about the length of the current expansion and whether it can be sustained.

In Canada, we forecast growth of 2.3% in 2018, a noticeable slowdown from the nearly 3% pace set in 2017. This slower performance nevertheless represents a very solid and broad-based expansion of activity, as our estimate of the rate of potential output growth remains 1.6%. The economy will move further into excess demand in 2018, leading to more inflationary pressure and higher interest rates. Capacity constraints will become even more prominent. Nowhere is this more evident than in the labour market, where jobs are being created at an extraordinary rate, wages are rising rapidly, the unemployment rate is at its lowest level since 1974 and the participation rate of those in their prime working-age years is near historic highs. Inflation, after disappointing on the downside for years, is on the rebound and is now picking up a bit more rapidly than our models

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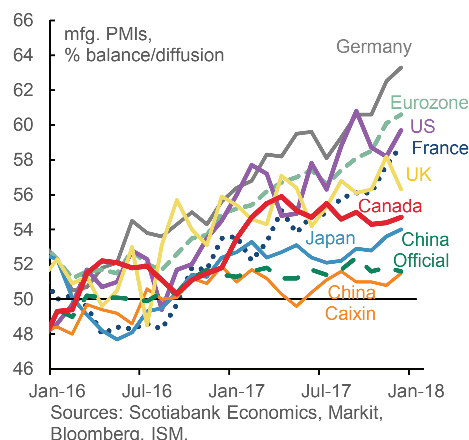
Chart 1



Sources: Scotiabank Economics, Markit, Bloomberg, ISM.

would suggest. The strength in activity continues to benefit federal government finances, as we now expect narrower deficits of CAD16.8 bn this fiscal year, and CAD15 bn next year.

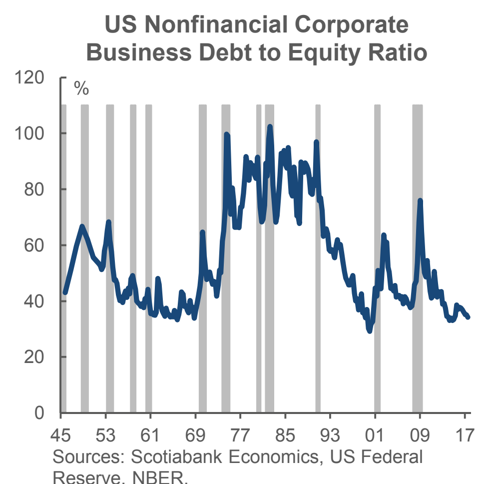
A number of risks cloud this outlook. First and foremost on the downside are the ongoing negotiations to update NAFTA. Our assumption is that negotiations will extend well beyond the March 31 deadline, and we may see President Trump initiate a withdrawal from the agreement as a bargaining ploy. There will be ups and downs in the negotiations, and uncertainty associated with the eventual outcome is bound to be a drag on the outlook. There are no visible signs of that yet in the incoming data, but we are pulling down our forecast a bit to account for this. The newly implemented B-20 rules risk triggering a slowdown in the Canadian housing market, a risk the Bank of Canada has flagged. We have shaved our projections marginally to account for this as well, though the fundamental drivers of the housing market remain solid. The minimum wage increase in Ontario and other associated labour-policy changes represents another potential source of uncertainty, but we are not yet building in any macroeconomic effects from these developments into our forecast. The empirical literature implies that economic impacts should be limited, though the speed of the increase in the minimum wage in Ontario, along with other associated measures, stands out as a more significant combination of policy changes than has been typically considered in past studies.

There are a number of positive risks that potentially offset these concerns. With labour income growing rapidly, fed by strong employment and wage gains, and asset prices remaining high, it is quite possible that consumption continues to increase much more rapidly than we currently forecast. The same is true for residential investment. We anticipate a slowdown in housing starts and softer markets in Toronto, but fundamentals remain strong and housing markets may prove to be more resilient than currently expected. It is worth nothing that we assumed the same dynamic this time last year with respect to consumption and housing: that they would slow in 2017 owing to a view that recent strength was unsustainable. Our assumption was proven wrong as consumption and housing were much stronger than expected in 2017. We may be surprised again in 2018.

Based on the economic environment alone, the case for higher interest rates in Canada is airtight. Other factors cloud the outlook. The Governor of the Bank of Canada remains concerned about the level of household indebtedness and how that will interact with rising interest rates. He is worried about a potential slowdown in the housing market triggered by the regulatory B-20 changes implemented on January 1. And though he is placing less public emphasis on this in recent communications, NAFTA-related concerns presumably still loom large. Due in part to these risks, the Bank of Canada has indicated that it will be data dependent. The challenge for the BoC will be to weigh these risks against incoming data—data that we expect to support a case for higher interest rates throughout the year. Incorporating some of these risks in our model-based approach leads us to forecast 75 basis points of gradual tightening this year, spread out throughout 2018. The first increase is expected on January 17, followed by increases in May and October. With a relatively unchanged interest rate differential against the US and oil prices expected to remain roughly at current levels, we forecast that the Canadian dollar will hover around 80 cents for most of the year.

Growth in the US is expected to mildly outpace that in Canada. As in Canada, the labour market remains reasonably strong and, in conjunction with high household wealth, this should support consumption through the year. Capital spending is forecast to remain reasonably strong as the industrial rebound broadens, and capacity pressures necessitate an increase in productive capacity. As confirmation, tracking shows orders of capital goods in the US are at their highest level in 5 years. A question in the mind of some observers is how much run room is left in the US given the length of the current expansion. Not all major variables are suggesting late-cycle risks. For instance, US household debt payments as a share of income sit at their lowest in three and a half decades and nominal wage growth looks mid-cycle at best to us. Corporate leverage remains low as well and has not begun to rise as it has typically prior to recessions (chart 2).

Chart 2



Sources: Scotiabank Economics, US Federal Reserve, NBER.

A key issue affecting our US forecast is the treatment of the tax reform package. On net, the package is expected to have only a marginal impact on the outlook. At least two factors are at play. The sizeable cut in corporate and personal income taxes is likely to merely provide a modest boost to growth based on the historical experience with tax cuts in the US. In addition, this modest boost hits when the economy is in excess demand and a withdrawal in stimulus is required. As a result, the Federal

Reserve is expected to tighten rates a bit more rapidly than earlier anticipated, and thus dampen some of the potential impact of lower taxes. Our forecast does not incorporate a rise in the US sovereign risk premium, though evidence suggests that the nearly trillion dollar deficit that will result from the tax package should lead investors to demand a higher rate of return on US government debt.

There is a compelling case for tighter monetary policy in the US. The core personal consumption expenditure deflator appears to be shaking off some of the factors that temporarily depressed it last year and our econometric analysis suggests that the link between output and inflation in the US is alive and well. With above potential growth forecast to continue, inflation should continue to rise, requiring less stimulative monetary policy. We forecast that the Federal Reserve will raise rates by 75 basis points this year, with the next increase in March.

The rise in short-term rates in the US and Canada will have a limited impact on longer-dated interest rates as the latter continue to be held down by low yields on government debt in Japan and Europe. We expect this will be the case so long as the Bank of Japan and European Central Bank maintain their quantitative easing programs. On that front, though growth in Japan and Europe has far exceeded expectations in 2017, with European growth set to increase to 2.4% in 2018, inflationary pressures remain virtually non-existent in both countries. Both central banks are likely to leave current policies in place for the foreseeable future.

A strong acceleration in growth is anticipated in the Pacific Alliance countries. This is most evident in Peru, Chile and Colombia, where a combination of higher commodity prices and political developments is expected to lead to higher business confidence, investment, and infrastructure spending. In Mexico, the upcoming Presidential election and NAFTA negotiations are weighing on the outlook, but growth is nevertheless expected to accelerate to 2.4% in 2018 owing to strong household spending and rising investment. For Mexico, as in Canada, the strength in the US and the rest of the world is proving to be a powerful tonic against trade-related uncertainties.

Table 1

Global Real GDP	2000–16	2016	2017e	2018f	2019f
	(annual % change)				
World (PPP)	3.9	3.2	3.7	3.8	3.6
Canada	2.1	1.4	2.9	2.3	1.7
United States	1.9	1.5	2.3	2.5	1.8
Mexico	2.2	2.9	2.1	2.4	2.8
United Kingdom	1.8	1.9	1.8	1.5	1.9
Euro zone	1.3	1.8	2.4	2.7	2.5
Germany	1.3	1.9	2.6	3.0	3.0
France	1.3	1.2	1.9	2.5	2.0
China	9.4	6.7	6.8	6.5	6.2
India	7.1	7.9	6.3	7.4	7.5
Japan	0.9	0.9	1.8	1.4	0.9
South Korea	4.2	2.8	3.2	2.9	3.0
Australia	3.0	2.6	2.4	2.7	2.5
Thailand	4.0	3.2	3.8	3.5	3.4
Brazil	2.6	-3.5	0.6	2.5	2.7
Colombia	4.1	2.0	1.7	2.5	3.5
Peru	5.1	3.9	2.5	3.7	4.2
Chile	4.1	1.6	1.4	2.8	3.2

Sources: Scotiabank Economics, Statistics Canada, BEA, BLS, IMF, Bloomberg.

Canada

- **Growth is expected to remain at or above potential well into 2019. Combined with tight labour markets and rising wages, which should dampen some of the Bank of Canada Governor's concerns about the Canadian economy, inflation is projected to move toward the Bank's 2% target by 2019 and prompt three policy rate increases in 2018 and three more in 2019.**

- **The year ahead is likely to be filled with volatile, and sometimes difficult, headlines on trade, but we expect NAFTA's key elements to remain in place through a 'shadow' period of uncertainty and agreement to be reached eventually on a renegotiated and modernized pact.**

GOLDILOCKS' PORRIDGE STARTS TO COOL

After running hot through the first half of 2017, Canada's economic momentum appeared to flag slightly in the second half of 2017, which led us to mark down our growth estimate for the year as a whole to a still impressive—and G-7 leading—2.9% real GDP expansion. Canadian growth should continue to decelerate gradually in line with its underlying trend through 2018 and 2019 as policy measures, including tighter mortgage qualification standards and higher interest rates, start to blunt spending by already heavily-indebted households. We project real GDP growth to cool to 2.3% in 2018 and further to 1.7% in 2019 (chart 1 and table 2), converging near our estimate of Canada's potential GDP growth rate of 1.6%.

While growth is expected to slow, the prospect of three successive years of expansions at or above potential implies that inflation should accelerate mildly over the next two years and reach the Bank of Canada's 2% target during 2019. Increases in provincial minimum wages will play only a very marginal role in pushing up prices as a closed output gap, low unemployment, rebounds in the oil-producing regions of the country, and catch-up in deferred market-wage increases should provide an organic boost to prices after years in which inflation has seemed unable to gain ground. As explained in the *Monetary Policy & Capital Markets* section, we expect the Bank of Canada to respond with three policy-rate increases in 2018 and three more in 2019 despite concerns about trade, real estate, household indebtedness, the labour market, and cybersecurity.

CONSUMERS STILL IN THE DRIVER'S SEAT: THEIR TAILWINDS HAVEN'T YET FADED

Canada's strong economic performance owes much to its spendthrift consumers. Real consumer spending increased almost 4% in 2017, the strongest annual advance since the immediate post-recession recovery in 2010. Auto makers tallied a fifth consecutive record year with sales exceeding two million vehicles for the first time.

A booming job market is fueling confidence and spending. The strongest pace of employment growth in a decade and a half has pushed the unemployment rate to

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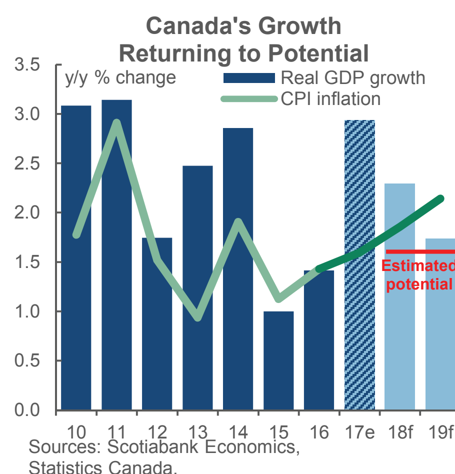
Chart 1



Sources: Scotiabank Economics, Statistics Canada.

5.7%, its lowest level in 43 years. Canada's prime-age employment-to-population ratio is at a record high of 82.7%. Almost all of the net new jobs added over the past year have been full-time positions (chart 2) and the January Bank of Canada Business Outlook Survey (BOS) notes that firms' hiring and wage intentions remain strong versus post-2008 norms.

The fundamental drivers of household spending remain favourable. Wage growth has picked up to nearly 3% y/y amid the tightening in labour market conditions. A further acceleration is anticipated in 2018, reinforced by legislated minimum wage increases (including annual inflation indexation) in nine provinces (chart 3). The Bank of Canada staff estimate the minimum wage increases will lift national real wages by 0.7% by 2019 without having a meaningful impact on either Canada-wide growth, inflation, or employment.

Wealth gains from rising home and equity prices have further bolstered household purchasing power. Household net worth increased by CAD 387 bn in the past year. Assuming a wealth effect of 4 cents on the dollar, this may have added upwards of one and a half percentage points to the annual increase in consumer spending.

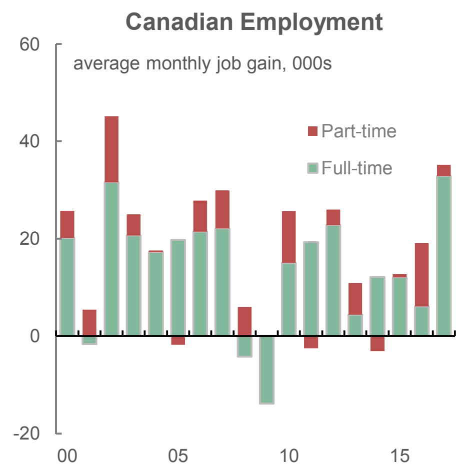
Solid population growth is boosting demand for goods and services. Fuelled by the highest nominal level of immigration in over a century, Canada's population has risen 1.3% in the past year, the fastest pace since the early 1990s and almost double the 0.7% increase in the US. Ottawa's announced increase in annual immigration targets, from 300,000 in 2017 to 340,000 by 2020, will take the immigration rate from eight to nine per one thousand of the Canadian population. Given the demographic tilt of newcomers under Canada's immigration point system, this should support solid household formation over the medium-term.

A surge in domestic and international tourism is underpinning travel-related service industries, including accommodation and food, transportation, and arts and recreation. Inflation-adjusted tourism expenditures increased 5% year-over-year through the first three quarters of 2017. The number of international visitors to Canada last year was on track to exceed 30 mn, its highest since 2006.

The tourism outlook remains positive, even as the fillip from last year's Canada 150 celebrations fades. A competitive Canadian dollar continues to attract international visitors to Canada, while at the same time limiting cross-border shopping by Canadians. Overseas visits to Canada are expected to reach a fifth consecutive annual record this year, benefiting from improved visa facilitation and increased airline capacity from a number of key markets, including Mexico, China, and India. Domestic travel intentions through early 2018 also remain elevated, on par with last year.

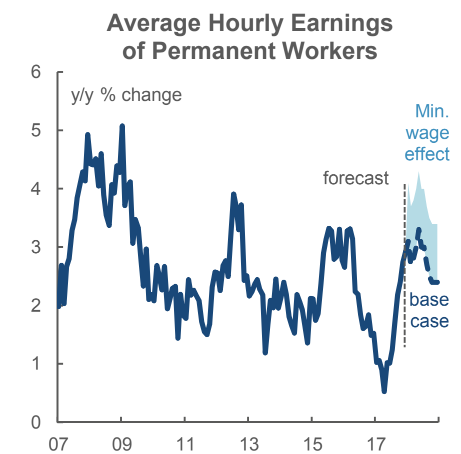
Even so, Canadian households are unlikely to maintain the torrid pace of spending of the past year. Families will receive some modest additional support as indexation of the Canada Child Benefit (CCB) begins in mid-2018, but the overall boost to growth from the CCB is set to fade. While hiring intentions remain firm, growing labour shortages may constrain the ability of employers to match available workers to job openings. Statistics Canada reported 468,000 job vacancies as of Q3 2017, a 15% increase from a year-earlier (chart 4). Rising vacancies were prevalent across industrial sectors and regions, with the largest increase in BC, Ontario, and Quebec. Job vacancies also are on the rise in Alberta, though the provincial vacancy rate remains slightly below the national average.

Chart 2



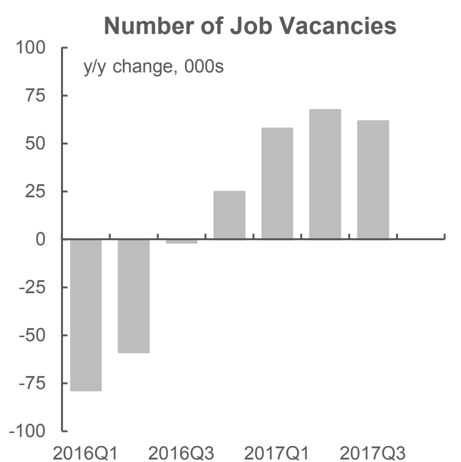
Sources: Scotiabank Economics, Statistics Canada.

Chart 3



Sources: Scotiabank Economics, Statistics Canada.

Chart 4



Sources: Scotiabank Economics, Statistics Canada.

Meanwhile, higher interest rates are expected to divert some discretionary spending toward debt servicing. Households on balance have a more limited savings cushion to finance purchases in excess of current income. While the pace of credit accumulation is relatively stable at 5.6% y/y, much of the recent boom in consumption has come at the expense of drawing down the savings rate below 3% for the first time since 2007.

A SOFT LANDING FOR CANADA'S HOUSING MARKET

Canada's housing market is displaying remarkable resilience despite its unprecedented late-cycle stage. National home sales rebounded strongly in the final months of 2017, though overall activity remains below its early-year peak. The pickup has been most pronounced in the Greater Golden Horseshoe as market sentiment adjusts to Ontario's April 2017 introduction of its Fair Housing Plan. It is also likely that some buyers brought forward their home purchases ahead of tighter mortgage qualifying rules that came into effect January 1st.

The combination of the new mortgage rules and higher interest rates is expected to lead to some moderation in national sales activity this year. The Bank of Canada estimates that about 10% of borrowers would be impacted by the new stress tests, including about 12% in Vancouver, Toronto, and surrounding areas. The overall impact on sales, however, is likely to be smaller, as some potential buyers may choose to purchase lower-priced homes, while others may be able to extend their amortization periods, make a larger down payment, or opt for a lower variable mortgage rate in order to extend their buying power. Some borrowers may turn to credit unions or private lenders not subject to the OSFI mortgage guidelines.

Housing demand fundamentals, including low unemployment, strengthening wage gains, aging millennials, and increased immigration, remain supportive. While affordability has become increasingly strained in the Greater Vancouver and Toronto-Hamilton Areas, it remains healthy in much of the rest of the country. National average price growth is forecast to remain positive, albeit more subdued in the low single digits, with the majority of local markets in balanced territory.

Moderately higher interest rates should be manageable for most borrowers. Roughly 70% of outstanding mortgages are fixed rate, with the five-year term being the most popular, and are thus impacted only gradually. Five-year terms rolling over in the coming year are likely to do so at rates only moderately higher than at origination, though a larger rate increase is likely for renewals at shorter-term durations. At the same time, borrowers may have higher incomes to manage increased payments as well as increased home equity that can be tapped.

Table 1

Quarterly Canadian Forecasts	2017		2018				2019			
	Q3	Q4e	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Economic										
Real GDP (q/q ann. % change)	1.7	2.0	2.6	2.2	1.9	1.9	1.6	1.6	1.5	1.5
Real GDP (y/y % change)	3.0	2.9	2.7	2.2	2.2	2.2	1.9	1.8	1.7	1.6
Consumer prices (y/y % change)	1.4	1.8	1.8	1.9	1.9	1.9	2.1	2.1	2.2	2.2
Avg. of new core CPIs (y/y % change)	1.5	1.7	1.7	1.8	1.9	1.9	2.0	2.0	2.0	2.0
Financial										
Canadian Dollar (USDCAD)	1.25	1.26	1.28	1.27	1.26	1.25	1.25	1.22	1.22	1.25
Canadian Dollar (CADUSD)	0.80	0.80	0.78	0.79	0.79	0.80	0.80	0.82	0.82	0.80
Bank of Canada Overnight Rate (%)	1.00	1.00	1.25	1.50	1.50	1.75	2.00	2.25	2.25	2.50
3-month T-bill (%)	1.00	1.06	1.30	1.55	1.55	1.80	2.05	2.30	2.30	2.50
2-year Canada (%)	1.52	1.69	1.90	2.05	2.20	2.30	2.40	2.50	2.55	2.65
5-year Canada (%)	1.75	1.87	2.05	2.15	2.30	2.45	2.55	2.60	2.65	2.75
10-year Canada (%)	2.10	2.05	2.20	2.30	2.45	2.60	2.65	2.70	2.75	2.85
30-year Canada (%)	2.48	2.27	2.35	2.50	2.75	2.90	3.00	3.10	3.15	3.10

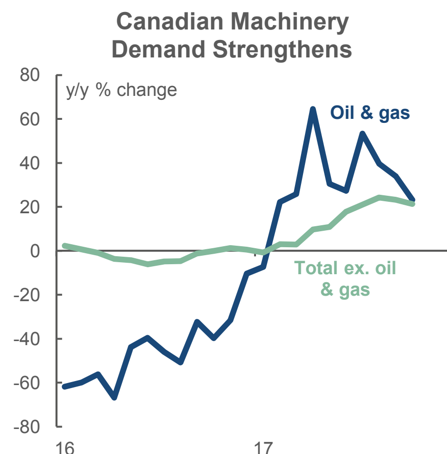
Sources: Scotiabank Economics, Statistics Canada, Bloomberg.

INVESTMENT IN MACHINERY DRIVES ORDER BACKLOG HIGHER

Industrial activity continues to expand at a faster pace than the more stable service sector, led by gains of nearly 20% y/y through October in both mining and machinery. This trend reflects a global upturn in business investment, which lifted capital expenditure growth among the advanced OECD economies to more than 3% y/y in the third quarter of 2017. This represents a sharp improvement from the decelerating trend that was in place during most of 2016, and is the best performance in more than three years.

A pickup in industrial activity and orders has lifted the production backlog at Canadian factories, outside of the auto sector, to record highs. A surge in demand for Canadian-made machinery accounts for much of the increase in the manufacturing backlog. The machinery sector has accounted for nearly 60% of the surge in the value of unfilled orders in Canada over the past year—roughly ten times its 6% share of overall Canadian manufacturing activity. Much of the surge in demand for Canadian machinery is coming from outside of Canada, as the sector exports more than 90% of its output, compared to only 54% for other manufacturers.

Chart 5



Sources: Scotiabank Economics, Statistics Canada.

Machinery demand has also picked up within Canada, reversing the declining trend that was in place from early 2015 through a year ago (chart 5). Rising operating rates and elevated business and consumer confidence, as well as a strengthening backlog are overwhelming the uncertainty created by the negotiations on the North American Free Trade Agreement (NAFTA), and prompting businesses to begin to open their purse strings. The rebound in machinery demand is strongest in Alberta, but has also picked up in other provinces. For example, machinery demand in Ontario, which accounts for nearly half of the Canadian total, jumped 9% y/y through October, and likely climbed to an annual record in 2017, buoyed by a double-digit increase in corporate profits and the highest manufacturing operating rates since 2000.

CANADIAN GOVERNMENTS: STILL SPENDING

Current and capital expenditures across all three levels of government are expected to add 0.4 percentage points to real GDP growth during 2018, before easing to a 0.2 percentage point contribution in 2019. Assisted by Phase 1 of the federal infrastructure program, execution of numerous projects across all regions is picking up, with social and green infrastructure initiatives such as social housing, daycare spaces, community facilities, and wastewater management, in addition to transportation and public-transit outlays, proceeding. Other new federal spending adjustments, owing to their complexity, will likely continue to face delays, with significant ongoing spillovers to future years.

The federal government's fiscal 2016–17 deficit came in at a narrower-than-expected CAD 17.8 bn, owing mainly to the reprofiling of previously-planned expenditure. Ottawa's efforts to sustain gradual improvements from this benchmark are being eased by the stronger-than-expected output and employment growth during calendar 2017 and related federal revenue adjustments. Compared with the government's projections this past October in its *Fall Economic Statement 2017*, which projected a widening in

Table 2

Canada	2000–16	2016	2017e	2018f	2019f
	(annual % change, unless noted)				
Real GDP	2.1	1.4	2.9	2.3	1.7
Consumer spending	2.9	2.3	3.6	2.8	1.9
Residential investment	3.7	3.4	2.6	-0.8	-0.9
Business investment	2.2	-8.8	1.5	3.6	2.6
Government	2.2	2.7	2.1	1.8	1.0
Exports	1.3	1.0	1.0	2.3	3.2
Imports	2.9	-1.0	3.3	2.4	2.7
Nominal GDP	4.2	2.0	5.1	4.3	4.0
GDP Deflator	2.1	0.6	2.1	2.0	2.3
Consumer price index (CPI)	1.9	1.4	1.6	1.9	2.1
CPI ex. food & energy	1.6	1.9	1.6	1.8	2.0
Pre-tax corporate profits	3.6	-1.9	20.0	5.0	1.0
Employment	1.3	0.7	1.9	1.5	0.8
Unemployment rate (%)	7.1	7.0	6.3	5.9	5.9
Current account balance (CAD bn)	-17.1	-65.4	-66.8	-66.4	-60.1
Merchandise trade balance (CAD bn)	25.1	-25.9	-24.7	-27.4	-24.2
Federal budget balance* (FY, CAD bn)	-2.8	-1.0	-17.8	-16.8	-14.8
percent of GDP	-0.2	0.0	-0.9	-0.8	-0.7
Housing starts (000s)	199	198	220	206	196
Motor vehicle sales (000s)	1,657	1,949	2,038	2,000	1,950
Industrial production	0.6	0.1	5.2	2.0	1.1
WTI oil (USD/bbl)	63	43	51	57	60
Nymex natural gas (USD/mmbtu)	4.94	2.55	3.02	2.95	2.95

Sources: Scotiabank Economics, Statistics Canada, CMHC, Bloomberg. * Canada ex risk adjustment of $1.5bn & $3.0bn for FY18 & FY19.

the deficit during fiscal 2017–18, we now expect this fiscal year's shortfall to narrow to CAD 16.8 bn (assuming the CAD 1.5 bn risk adjustment is not required) and to keep contracting in fiscal 2018–19 to less than CAD 15 bn, an improvement of almost CAD 10 bn from last spring's *Budget* estimate if the CAD 3 bn risk provisioning is not invoked. Enhancing federal fiscal flexibility are the rising revenues anticipated from the recent policy changes on the taxation of corporate passive investment income. Achieving our projected federal deficits would edge Ottawa's accumulated deficit below 30% of GDP by March 2019 for the first time since March 2009.

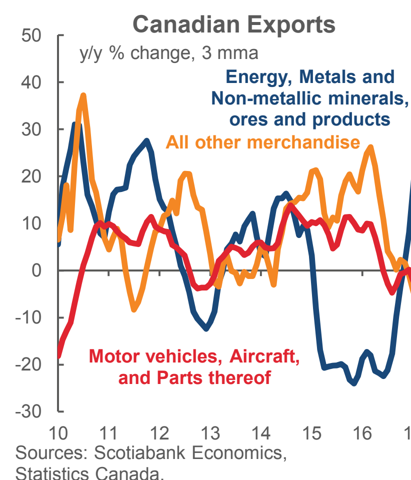
The Provinces are evenly divided between those that are set to maintain balanced books from fiscal 2017–18 onward and those that are still working to eliminate their remaining budget shortfalls in the years ahead. In general, the Provinces have less forward fiscal flexibility than their federal counterparts owing to three key issues: first, all ten governments face their usual spending pressures in health, education, social services, and senior care; second, they may feel compelled to raise matching funds for federal initiatives in, amongst other things, infrastructure, the environment, and indigenous services; and third, new priorities, such as efforts to dampen power price increases, have arisen.

The recent US tax reform erodes almost entirely Canada's sizeable prior advantage in corporate taxation, in terms of both the combined federal and provincial/state statutory rates and the marginal effective tax rate on new capital investment. Tax rates aren't, however, the only consideration in business decisions: the federal and provincial governments could act to enhance competitiveness with tax-policy adjustments, regulatory reforms, and other measures, all of which could be engineered to be revenue-neutral for government.

IMPROVING GLOBAL ECONOMIC CONFIDENCE TO LIFT CANADIAN MANUFACTURING EXPORTS

In 2017, Canadian merchandise exports expanded at around 5% y/y, but showed trends that contrasted sharply between each half of the year. Until June, monthly goods exports averaged double-digit growth, led by an increase in energy products exports that averaged slightly over 60% growth year-on-year, which compensated for declines in several industrial product exports. During the second half of the year, softer, but still strong, commodities exports were unable to compensate fully for retreats concentrated in other sectors, namely motor vehicles, aircraft, and their respective parts (chart 6). Yet, industrial machinery exports are set to get a boost from increased global demand for manufactured goods, with world industrial production growing at its fastest pace in more than three years.

Chart 6



Sources: Scotiabank Economics, Statistics Canada.

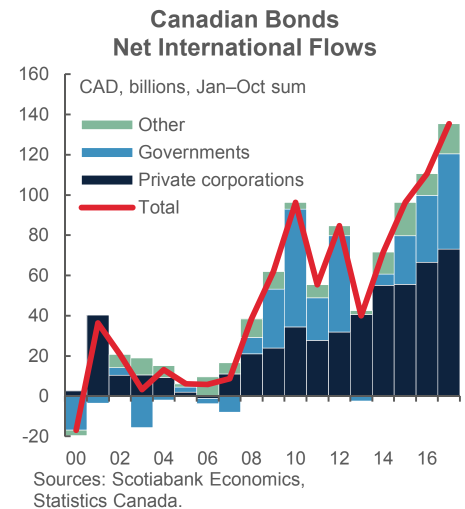
Industrial capacity pressures in the US, alongside tax reforms that make capital equipment investments more advantageous, should lead to increased demand for Canadian industrial goods in 2018. Motor vehicles exports south of the border are also set to rebound as US auto dealer inventories dwindle, personal consumption remains strong, and pickup truck production ramps up in Oshawa. The fly in the Canadian export ointment continues to be uncertainty surrounding NAFTA and the imposition of countervailing duties by the US on certain Canadian products such as airplanes, softwood lumber, and some paper products.

Nevertheless, the Bank of Canada BOS puts Canadian firms' investment intentions near post-2008 highs and we expect Canadian goods exports to expand by around 0.9% y/y in 2018 in dollar terms, below the projected 1.3% y/y growth in imports. During the second half of 2018, merchandise export growth should slightly exceed import growth and carry into 2019. On a quarterly basis, the country's merchandise trade deficit is expected to narrow from its 2017 high of CAD 36 bn to the low CAD 20 bn range by end-2019. Together with narrowing in the services and non-merchandise trade balances, Canada's current account deficit is projected to fall from an estimated 3.1% of GDP in 2017 to 3.0% of GDP and 2.6% of GDP in 2018 and 2019, respectively.

CAPITAL INFLOWS TO DEBT MARKETS STEP UP

Last year saw large capital flows from international investors into Canadian securities, with the 12-month total net flow from October 2016 to 2017 amounting to close to 5.5% of Canadian GDP, up from 4.9% in the previous year. On a year-to-date basis, government bond acquisitions by foreigners grew 43% y/y versus 10% y/y for corporate bonds (chart 7). While net foreign purchases of debt securities are more than double those of equities, the latter saw a massive 67% y/y increase in the year to October owing to record-breaking investment in Canadian shares in February 2017 related to cross-border mergers and acquisitions activity, which is unlikely to be repeated this year. Overall, Canada's gross external debt (public and private) has stabilized at around 110% of GDP since late-2015, after a steep rise in banks' external funding which climbed from 24% of GDP in 2013 to as high as 46% of GDP in 2016. Since its Q4-2016 peak, the ratio of banks' gross external debt to Canadian GDP has fallen to 41% in Q3-2017 as foreign deposit growth has levelled off while banks' debt in the form of long-term instruments has remained on a nearly constant climb.

Chart 7



Sources: Scotiabank Economics, Statistics Canada.

RISKS: INSOMNIA SHOULD BE WANING

Over the last few months, Bank of Canada Governor Poloz has articulated five major concerns for the Canadian outlook: trade relations with the US under NAFTA, stretched home real-estate valuations, household indebtedness, the labour market, and cybersecurity. While all five issues are important considerations for policy makers, we don't expect developments on any of these fronts to meaningfully derail the outlook we've sketched for the Canadian economy. As we detailed in several reports on our NAFTA microsite (*www.scotiabank.com/nafta*), it is likely that the tone of our trade talks with the US and Mexico will intensify over the coming months, that agreement on a renegotiated and modernized NAFTA may not be reached by the current end-March deadline, and that the NAFTA discussions may enter a 'shadow' period during the remainder of 2018 during which the agreement remains in effect, but its future seems uncertain. A series of key US dates (box 1) may prompt efforts by the White House to increase pressure on Canada and Mexico, including through threats to withdraw from NAFTA. Investors, businesses, and households should look through these tensions: the incentives remain aligned for eventual agreement on a revised NAFTA, but we may not see a consensus on how this will look until 2019. As detailed above, recent jobs data imply that labour markets are running hot enough to prompt wage increases that should ease worries about debt levels and housing affordability, while immigration and capital inflows are set to sustain real-estate markets. Canadian government and business are responding to cybersecurity threats, and we do not see macroeconomic implications from these threats at this stage.

Additional areas of uncertainty could arise around the introduction of Canada's carbon-pricing regime, long-term erosion in our corporate tax competitiveness as a result of US fiscal reform, and increasing labour-market rigidity following the introduction of a host of provincial measures that go well beyond increases in minimum wages. These are, however, longer-term issues that could affect Canada's performance over the next five to 10 years, rather than crimp the outlook for 2018 and 2019.

Box 1. KEY NAFTA-RELEVANT US RISK DATES DURING 2018

While NAFTA talks are tentatively set to conclude by end-March 2018, it is likely that they could be extended into next year: Mexico's presidential elections in July and the US Congressional midterm elections in November could both inhibit meaningful progress from Q2 to Q4 2018. Intensified rhetoric and more pointed negotiating tactics are likely to surface around the following dates, which could set off difficult headlines, but should not meaningfully change our expectation that NAFTA's key provisions will remain in place.

- **January 23–28.** Sixth round of NAFTA negotiations in Montréal, Canada.
- **January 25.** US International Trade Commission's final voting phase on antidumping and countervailing duty investigations into 100- to 150-seat aircraft from Canada.
- **January 30.** US President's State of the Union Address to Congress. The President is likely to highlight his protectionist agenda and raise concerns about the country's largest trading partners: Canada, China and Mexico. Immigration policy regarding Mexico may also figure in the speech.
- **January 31.** Self-imposed deadline by Senate Majority Leader on immigration reform.
- **Mid-February.** Seventh round of negotiations in Mexico.
- **March 5.** Deferred Action for Childhood Arrivals (DACA) permits begin expiring in the US.
- **Mid-March**. Eighth round of negotiations in Washington, DC
- **End-March.** Tentative deadline for conclusion of NAFTA negotiations and deadline for any request to Congress to extend the 2015 Trade Promotion Authority (TPA) and/or to submit to Congress any proposed changes to NAFTA, both of which require a 90-day notice period ahead of the existing TPA's expiry at end-June.
- **Early-April.** If the US were to invoke NAFTA's Article 2205 withdrawal clause at this point, its six-month notice period would conclude around the time of the US Congressional midterm elections in November.
- **May 23.** US Department of Commerce to make final determination on countervailing duties on uncoated groundwood paper from Canada.
- **End-June 2018.** The 2015 TPA expires. TPA must be extended or renegotiated in order to present changes to NAFTA to Congress subject to only an up-down vote without amendments.
- **By end-June.** Comprehensive and Progressive Trans-Pacific Partnership (CPTPP) expected to be ratified by six of the 11 member countries, thereby bringing it into force for those countries.
- **July 1.** Mexican presidential, congressional and state elections.
- **November 6.** US midterm elections along with some State elections.

The Provinces

BUILDING ON SLOWER GROWTH

- **Positive real GDP growth, albeit slowing, is forecast for all provinces in 2018 and 2019 for the first time since 2010–11. Alberta and British Columbia will lead the pack.**
- **With operating deficits curtailed, the Provinces' net new borrowing will be increasingly dominated by capital investment (chart 1).**

Growth leadership for 2018–19 remains with British Columbia and Alberta, though their expansion is expected to decelerate sharply by 2019 (table 1). The other provinces emerge from a surprisingly buoyant 2017 with varied growth engines that should sustain some momentum—from rising Halifax Shipyard activity to robust orders for buses in Manitoba and overseas demand for the Prairies' pulse crops.

Entering 2018, Alberta is estimated to have recouped just over half of its two-year 7.2% real GDP decline during 2015–16 and Saskatchewan has regained all of its 1.5% two-year fall-off. Anchoring these recoveries was an unexpectedly large rebound in energy sector investment, concentrated in supporting infrastructure and conventional oil & gas. The Line 3 oil pipeline replacement is proceeding but, overall, more muted energy-related investment gains are now anticipated as conventional capital outlays climb more slowly and oil sands investment stabilizes before commencing a careful upturn. Similarly, last year's export gains (chart 4), based on solid oil production increases of 9.0% for Alberta and 3½% for Saskatchewan and Newfoundland and Labrador, will be dampened in 2018–19 with the completion of the major oil sands projects started before the oil price correction. Newfoundland and Labrador's positive but weak growth this year and next reflects output ramping up at its fourth offshore oil field and the West White Rose offshore development, as work winds down on the Muskrat Falls hydroelectricity project. In all three net oil-producing provinces, the pent-up demand aiding 2017 consumer spending and the replacement purchases for the Fort McMurray rebuild are now expected to wane.

The extended mining sector recovery is expected to leave more balanced regional population growth intact for the rest of the decade. The net outflow of Alberta's and Saskatchewan's residents to other provinces that exceeded 23,000 in 2016 is receding, but a return to substantial net worker inflows is not anticipated through 2019, preserving other provinces' work forces. For international immigration, the broadening provincial distribution since 2000 lays the framework for all provinces to more fully benefit from the planned national immigration increase to 340,000 by 2020 from 300,000 annually in 2016–17 and a 262,000 average for 2012–15 (chart 2).

Alongside higher immigration, employment growth in 2017 across the net oil-consuming provinces matched or exceeded prior post-recession highs, a positive development for both housing demand and consumption. Yet the factors previously expected to spur increasing household caution over the next two years are still in place. Rising interest rates, regulatory tightening, a diminishing impact from higher federal child benefits and a late cycle consumer with an extended balance sheet are still hurdles. The late-2017 job creation surge is expected to cool as 2018 proceeds

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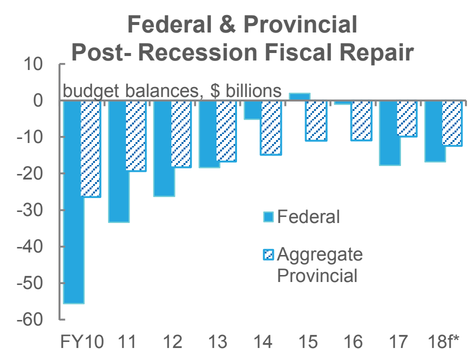
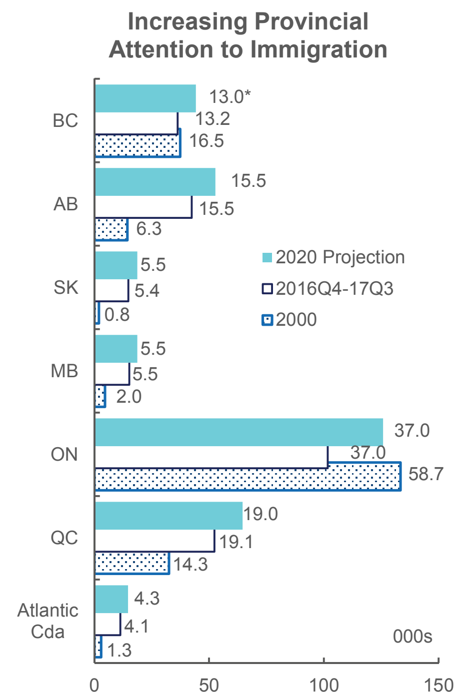
Chart 1



* FY18: provincial *Budgets*; federal: Scotiabank Economics. Sources: Scotiabank Economics, Finance Canada, provincial *Budget* documents.

Chart 2



* Per cent of national immigration. Sources: Statistics Canada, Scotiabank Economics.

and ease further in most provinces in 2019. Some offset to slower job gains is expected from wages trending upward (chart 3) through the forecast period, a shift reinforced by minimum wage hikes, particularly in Ontario and Alberta, this year and next. Labour market tightness in high-growth areas will add to wage pressures, though rising inflation is expected to partially dampen real purchasing power. Further growth, though more gradual, is forecast for tourists' spending, supported by the ongoing renewal and expansion of tourism facilities across the provinces.

The strong fundamentals underpinning housing demand in the high-priced Toronto and Vancouver markets is spilling over to adjacent centres—Victoria, Abbotsford and Kelowna in BC and in Ontario, Hamilton and Oshawa among others. In these nearby housing markets, decreased inventories, very low rental vacancy rates and rising prices and rents are limiting choice and reducing affordability. In Manitoba, Quebec and the Atlantic provinces, a moderate pick-up in housing demand is occurring in their major cities, in part due to the uptick in local economic growth. These centres, however, have the benefit of more ample housing supply to cushion the impact on their housing affordability.

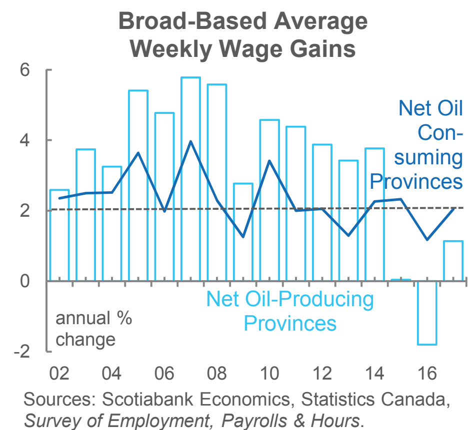
Rising exports across multiple non-energy industries (chart 4) are spurring investment that in turn is elevating demand for products such as fabricated metals and machinery and a range of support services. Most provinces are expected to benefit from strengthening US demand for consumer products, including motor vehicles, and industrial goods. Provincial mining sector prospects, apart from oil & natural gas, are mixed. The further price increases forecast for industrial base metals are encouraging and new capacity is opening in industries such as gold mining, but excess global supply is still projected for key minerals such as potash and uranium through 2019.

In the shadow of NAFTA negotiations, with the outline of an agreement unlikely by this March, the impact of existing and potential US trade actions varies. For softwood lumber, strong US demand stemming from rising residential construction has mitigated the overall impact of substantive countervailing and anti-dumping duties. Greater damage could result from the recently announced levies on Canadian newsprint because of the weaker market conditions for this product. Major aerospace activity is affected by US trade actions, but significant gains among smaller players in areas such as parts, overhaul and maintenance are reported in several provinces. In Ontario, after a strike and line closure last fall, a 9¾% jump of in motor vehicles assembled is expected from Q42017 to Q12018, but the sector, including pick-up trucks, is still subject to ongoing NAFTA discussions on "rules of origin".

A range of business services and services exports, from finance to scientific & technical inputs, should continue to accelerate regional employment and income growth. Technology's expanding role is well documented by the job surge of nearly 19% from 2006 to 2016 in computer & information systems (C&I) occupations, an increase that was more than double the total employment gain. In addition to C&I job creation in southern BC and Ontario's tech corridor stretching from Ottawa to Kitchener-Waterloo, significant concentrations exist in smaller centres such as Quebec City, Halifax and Fredericton (chart 5).

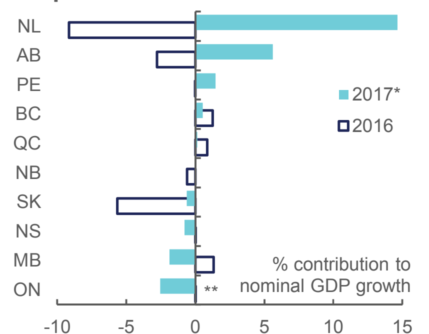
Inflation was relatively modest in a number of provinces through most of 2017 but started to quicken late last year, even in Quebec where the price response to stronger growth has been slow. High-growth areas already are seeing some price pressures, with y/y increases in Vancouver's non-residential construction price index topping 5%.

Chart 3



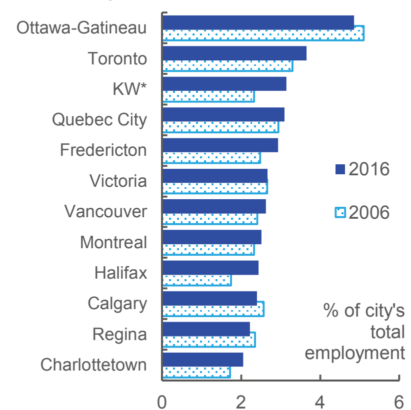
Sources: Scotiabank Economics, Statistics Canada, *Survey of Employment, Payrolls & Hours*.

Chart 4



* January. - November. ** Ontario, 2016: 0. Source: Statistics Canada.

Chart 5



* Kitchener-Cambridge-Waterloo. Source: Statistics Canada.

OLD AND NEW PROVINCIAL FISCAL CHALLENGES

With our forecast of 2017 real GDP growth for every Province surpassing their *Budget* assumptions last spring, some quite positive bottom line revisions were anticipated in their mid-year updates for fiscal 2017–18 (FY18). Their reports, however, indicated disappointing personal income tax revenues as households' tax planning in 2015 in advance of the federal top bracket rate hike in 2016 eroded the projected income base. Even with solid corporate and sales tax results, and the outlook for improving resource receipts despite possible weakness in bitumen prices, staying on track or improving upon fiscal plans this fiscal year and next is likely to require some difficult trade-offs for a number of Provinces.

To trim provincial net debt burdens run up relative to pre-recession levels for all but three Provinces, elevated capital spending to leverage available federal funding remains a hurdle. The Provinces and their municipalities also must accommodate the operating and maintenance expense of the new infrastructure. As they balance competing demands, a key provincial advantage given our forecast of higher interest rates is their post-recession success in lengthening the term of their debt when coupon rates were low.

Table 1

The Provinces	(annual % change except where noted)										
Real GDP	**CA**	**NL**	**PE**	**NS**	**NB**	**QC**	**ON**	**MB**	**SK**	**AB**	**BC**
2000–16	2.1	2.5	1.7	1.3	1.2	1.7	2.0	2.3	2.0	2.7	2.8
2016	1.4	1.9	2.3	0.8	1.2	1.4	2.6	2.2	-0.5	-3.7	3.5
2017e	2.9	-1.5	1.8	1.6	1.4	2.7	2.9	2.3	1.9	4.2	3.5
2018f	2.3	0.1	1.5	1.1	1.1	2.0	2.3	2.0	2.1	2.5	2.5
2019f	1.7	0.7	1.1	0.8	0.5	1.5	1.8	1.5	1.7	1.9	1.8
Nominal GDP											
2000–16	4.2	5.6	4.2	3.4	3.3	3.6	3.8	4.4	5.3	5.9	4.5
2016	2.0	2.6	4.0	2.8	3.6	2.7	4.3	2.3	-4.0	-4.9	4.8
2017e	5.1	2.6	3.6	3.2	3.0	3.8	5.0	4.0	4.9	7.6	5.6
2018f	4.3	3.0	3.2	2.8	2.7	3.6	4.5	3.7	4.1	4.9	4.6
2019f	4.0	4.0	2.9	2.6	2.2	3.3	4.0	3.3	4.2	5.0	4.0
Employment											
2000–16	1.3	0.8	1.0	0.6	0.4	1.3	1.3	0.9	1.1	2.3	1.4
2016	0.7	-1.5	-2.3	-0.4	-0.1	0.9	1.1	-0.4	-0.9	-1.6	3.2
2017	1.9	-3.7	3.1	0.6	0.4	2.2	1.8	1.7	-0.2	1.0	3.7
2018f	1.5	-0.8	0.6	0.4	0.3	1.5	1.6	0.8	0.5	1.5	1.7
2019f	0.8	-0.4	0.4	0.2	0.1	0.7	1.0	0.5	0.6	1.0	1.1
Unemployment Rate (%)											
2000–16	7.1	14.3	11.2	8.8	9.6	8.0	7.1	5.1	5.0	5.1	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
2017	6.3	14.8	9.8	8.4	8.1	6.1	6.0	5.4	6.3	7.8	5.1
2018f	5.9	14.9	9.7	8.1	7.9	5.6	5.6	5.3	6.0	7.3	4.9
2019f	5.9	15.0	9.6	8.0	7.8	5.6	5.6	5.2	5.9	7.2	4.8
Housing Starts (units, 000s)											
2000–16	199	2.6	0.7	4.3	3.5	44	71	5.1	5.2	34	28
2016	198	1.4	0.6	3.8	1.8	39	75	5.3	4.8	25	42
2017e	220	1.4	0.9	4.0	2.3	46	79	7.5	4.9	29	44
2018f	206	1.3	0.9	3.8	2.1	41	75	6.5	5.0	29	41
2019f	196	1.4	0.8	3.8	2.1	38	71	6.2	4.9	30	38
Motor Vehicle Sales (units, 000s)											
2000–16	1,657	29	6	48	38	413	635	47	45	216	180
2016	1,949	33	9	54	44	458	807	55	51	220	218
2017e	2,030	34	8	58	42	450	845	60	55	248	230
2018f	2,000	32	8	57	41	444	825	59	56	251	227
2019f	1,950	30	7	56	40	433	795	58	56	253	222
Budget Balances, Fiscal Year Ending March 31 (CAD mn)											
2000–16*	-2,803	-93	-38	-30	-153	-821	-5,115	-142	360	1,064	319
2016	-987	-2,206	-13	-13	-261	2,191	-3,515	-839	-675	-6,442	811
2017	-17,770	-1,148	-1	150	-119	2,361	-991	-764	-1,354	-10,784	2,737
2018f**	-16,800	-778	1	132	-135	0	0	-840	-679	-10,064	190
2019f	-14,800	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a

Sources: Scotiabank Economics, Statistics Canada, CMHC, Budget documents. * MB:FY04–FY16; AB:FY05–FY16; SK:FY15–FY18f: ex. accrual adjustment for pension expense.
** Provinces' FY18: Budget documents. Federal FY18-FY19: Scotiabank Economics forecast ex risk adjustment of $1.5bn and $3.0bn for FY18 & FY19, respectively.

United States

- **Building on a strong finish to 2017, US growth momentum is expected to carry into 2018 before reverting back toward underlying potential in 2019.**
- **The recently-approved package of federal tax cuts is expected to contribute only a marginal addition to annual growth in an economy already firing on most cylinders with a closed output gap, tight labour markets, and strong household consumption.**
- **Inflation is expected to continuing edging up beyond 2% by mid-2018, prompting the Fed to follow through with three rate increases in 2018 and two more in 2019, to reach a terminal rate of 2.75%.**

MOMENTUM CARRIES INTO 2018

The US closed out 2017 on a relatively high note, with strengthening data on economic activity matched by optimism connected to the passage of USD 1.5 tn in federal tax cuts for the next decade that should put US business on a more competitive footing compared with their foreign counterparts (chart 1). We expect a solid hand-off into the first half of 2018, with real GDP growth projected to rise from 2.3% in 2017 to 2.5% in 2018, with some moderation toward potential at 1.8% in 2019, far short of the White House's targets. The composition of growth is expected to improve somewhat as strong consumption growth is increasingly matched by broadening industrial activity and stepped-up business investment, spurred in part by the tax changes that provide more advantageous treatment of capital equipment purchases. But overall, federal tax reform is expected to add only a marginal contribution to economy-wide real GDP in its initial years: the output gap is already closed, labour markets are tight with unemployment at a cycle-low, personal tax reductions are skewed toward high-income earners with relatively low marginal propensities to spend their savings, and most studies imply that ongoing increases in business investment stemming directly from the tax changes will be small. Farther out, the tax package is likely to become a drag on growth as some tax cuts expire.

Tighter labour and product markets, waning deflationary effects from the greenback, and an economy that continues to grow above potential imply that inflation will edge above 2% by mid-2018 and remain there through 2019. This should prompt the Fed to follow through with the three rate increases anticipated in the Federal Open Market Committee's (FOMC) dot plots for 2018 and two more during 2019, as outlined in the *Monetary Policy & Capital Markets* section.

STRONG JOB MARKET FUELS STEADY SPENDING GAINS

Consumers remain the backbone of the US expansion. Strength in big-ticket demand for motor vehicles, household furnishings and equipment has lifted real purchases of durable goods by more than 6% year-over-year, more than double the increase in non-durables and services. Confidence and spending are well supported by low unemployment testing the 4% threshold for the first time in almost two decades, strong wealth gains from rising home and equity prices, and still-low borrowing costs.

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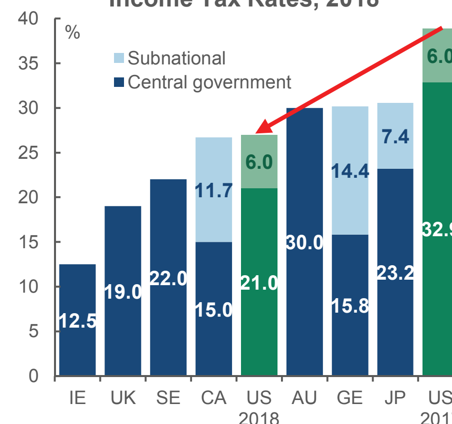
Chart 1



Sources: Scotiabank Economics, OECD.

Household consumption has been financed partly by increased borrowing and reduced saving, which could constrain spending going forward. Credit market debt as a share of disposable income has edged higher since early 2016, though it remains more than 25 percentage points below the 2007 peak (chart 2). The aggregate household savings rate has dropped three percentage points over the same period to 2.9%, its lowest level in a decade.

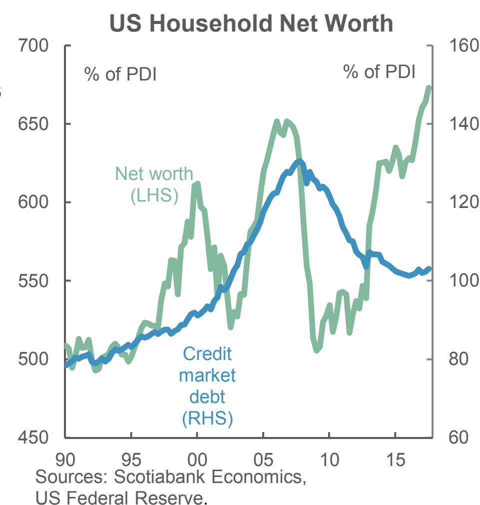
Household balance sheets, overall, remain quite healthy. Average household net worth is at record levels. Debt-servicing costs as a share of disposable income are near record lows. Just 5% of mortgage holders have negative home equity, down from a peak of 26% in 2009. Delinquency rates are low, though they are edging up for some types of lending, including credit-card balances.

Wage trends are forecast to accelerate this year with the US labour market at or near full employment, and a long-awaited pickup in productivity growth beginning to take hold. The broad U-6 measure of 'underemployment' that takes into account marginally attached workers and involuntary part-time workers is near a cycle low 8.1% (chart 3). Initial jobless claims are near historic lows. Job vacancies are trending near a record 6 mn unfilled positions, with reports of labour shortages becoming increasingly broad-based across industrial sectors.

Firmer wage gains should maintain relatively steady real spending growth of around 2.5% in 2018 despite some expected slowing in the pace of hiring. Household earnings and purchasing power are getting a lift from minimum wage increases in 18 states as of January 1, 2018, with two more states set for increases on July 1. Consumer spending should be supported also by personal income tax relief. However, the gains from these tax reforms are skewed toward higher-income earners with a lower marginal propensity to spend compared with lower-income households. As a result, the change in personal income taxes is expected to have only a very modest impact on broad consumption growth.

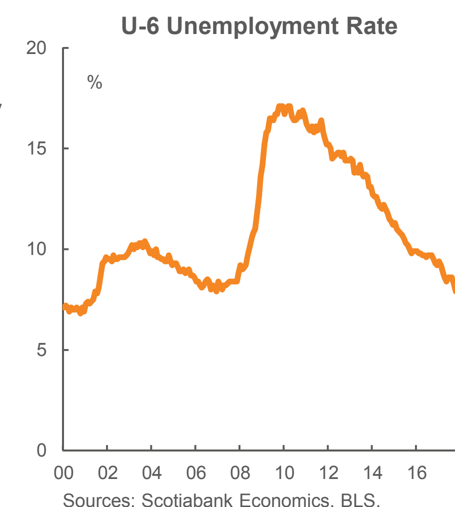
Meanwhile, weaker international tourism inflows are likely to continue to weigh on some retail and hospitality sectors. The number of international visitors to the United States in the first seven months of 2017 fell 4% from the same period a year earlier amid new travel restrictions and a strong US dollar (chart 4). Leading indicators of international long-haul bookings to the United States suggest a continued cool travel climate for 2018, in contrast to the generally bright outlook globally.

Chart 2



Sources: Scotiabank Economics, US Federal Reserve.

Chart 3



Sources: Scotiabank Economics, BLS.

Table 1

Quarterly US Forecasts	2017		2018				2019			
	Q3	Q4e	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Economic										
Real GDP (q/q ann. % change)	3.2	2.8	2.4	2.2	2.1	1.9	1.6	1.6	1.6	1.6
Real GDP (y/y % change)	2.3	2.5	2.8	2.6	2.4	2.2	2.0	1.8	1.7	1.6
Consumer prices (y/y % change)	2.0	2.0	2.0	2.3	2.3	2.2	2.2	2.3	2.4	2.4
CPI ex. food & energy (y/y % change)	1.7	1.8	1.8	2.1	2.2	2.2	2.2	2.2	2.3	2.3
Financial										
Euro (EURUSD)	1.18	1.20	1.18	1.18	1.20	1.20	1.24	1.24	1.28	1.28
U.K. Pound (GBPUSD)	1.34	1.35	1.35	1.35	1.37	1.37	1.38	1.38	1.40	1.40
Japanese Yen (USDJPY)	113	113	114	114	115	115	118	118	120	120
Fed Funds Rate (upper bound, %)	1.25	1.50	1.75	1.75	2.00	2.25	2.25	2.50	2.50	2.75
3-month T-bill (%)	1.04	1.38	1.80	1.80	2.05	2.30	2.30	2.55	2.60	2.80
2-year Treasury (%)	1.48	1.88	2.20	2.30	2.50	2.60	2.70	2.75	2.85	2.90
5-year Treasury (%)	1.93	2.21	2.50	2.60	2.70	2.75	2.85	2.90	3.00	3.05
10-year Treasury (%)	2.34	2.40	2.70	2.80	2.85	2.90	3.00	3.05	3.15	3.20
30-year Treasury (%)	2.86	2.74	2.85	2.95	3.00	3.05	3.15	3.20	3.30	3.35

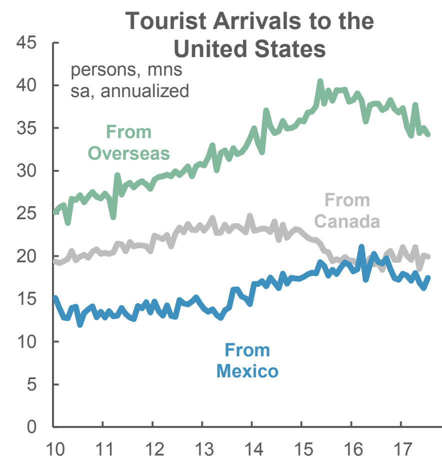
Sources: Scotiabank Economics, BEA, BLS, Bloomberg.

US HOUSING CYCLE STILL HAS ROOM TO RUN

The US housing market is showing renewed vigour. Existing home sales accelerated sharply in the final months of 2017, after appearing to stagnate through much of the year. Hurricane-related recoveries in the South have aided the recovery, but the improved momentum has been broadly based well beyond these regions.

Demand fundamentals remain favourable, including robust job growth, rising incomes, still-low borrowing costs, and a modest easing in bank lending standards for residential mortgages. Millennials entering their prime home-buying years represent an ongoing source of pent-up demand. For the first time since the 2007 housing crash, owner-occupied household formation is outpacing the number of new renter households, leading to a modest upturn in the homeownership rate.

Chart 4



Sources: Scotiabank Economics, US National Travel & Tourism Office.

Yet, the industry is facing several headwinds, including deteriorating—though still decent—affordability. The combination of higher home prices and rising interest rates has boosted total mortgage principal and interest payments for buyers by 10% over the past year, outpacing the 4% increase in median family income over the same period. Record-high student debt loads and rising rents further lift the savings bar for first-time homebuyers, whose share of purchases remains stuck under one-third, compared with a historical average of 40%.

A persistent shortage of inventory, most notably for entry-level homes, is also restraining activity. The pool of existing homes for sale has fallen to its lowest level in at least 18 years, representing just 3.4 months' supply. The dearth of resale listings has prompted more buyers to turn to the much smaller new home market, where sales are tracking their strongest pace in a decade.

Builders are responding, ramping up single-family starts by almost 10% last year. While this points to some supply relief in the pipeline, the overall rate of new construction will remain constrained by labour shortages and rising land and construction costs. Starts are forecast to climb to 1.25 mn units this year and 1.30 mn in 2019, up from an estimated 1.21 mn units in 2017. However, this still falls short of the estimated 1.40–1.50 mn annual units needed to plug the inventory gap.

INDUSTRIAL ACTIVITY BROADENS OUT

US industrial activity continues to strengthen and broaden out, pointing to an increasingly self-sustaining economic expansion. Demand for manufactured goods is accelerating in the US and across the world, and continues to outpace production gains. The economically-sensitive resource sector and capital goods are in the forefront of growth, and are widening their lead over less cyclical sectors, such as food processing. For example, US shipments of metals and machinery advanced 9% y/y in the four months to November, the best performance since the opening months of 2012. These sectors have historically provided good 'early warning signals' of potential economic pitfalls ahead, but are currently experiencing rising order backlogs which point to an 'all clear' sign for more room to run in the ongoing US economic expansion that is already the third-longest on record, and will become the second-longest by May 2018.

Industrial activity in the US, and indeed, across North America, is also starting to get a boost from the auto sector,

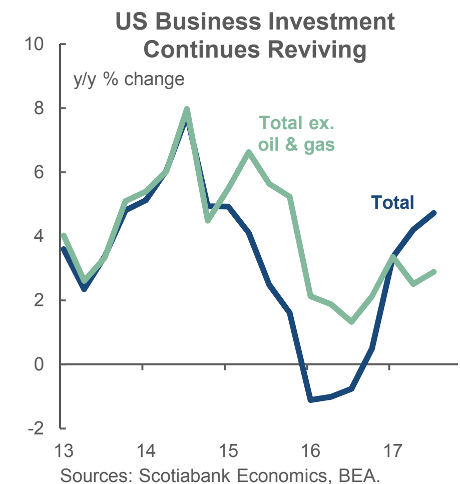
Table 2

United States	**2000–16**	**2016**	**2017e**	**2018f**	**2019f**
	(annual % change, unless noted)				
Real GDP	1.9	1.5	2.3	2.5	1.8
Consumer spending	2.4	2.7	2.7	2.6	2.1
Residential investment	-0.4	5.5	1.3	1.8	1.7
Business investment	2.3	-0.6	4.6	4.4	2.5
Government	1.0	0.8	0.0	0.5	0.4
Exports	3.6	-0.3	3.1	2.6	2.7
Imports	3.4	1.3	3.3	2.8	3.2
Nominal GDP	3.9	2.8	4.1	4.4	3.8
GDP Deflator	2.0	1.3	1.8	1.9	2.0
Consumer price index (CPI)	2.2	1.3	2.1	2.2	2.3
CPI ex. food & energy	2.0	2.2	1.8	2.1	2.2
Pre-tax corporate profits	5.5	-2.1	5.0	4.4	0.5
Employment	0.7	1.8	1.5	1.3	1.0
Unemployment rate (%)	6.2	4.9	4.4	4.0	4.0
Current account balance (USD bn)	-507	-452	-443	-450	-498
Merchandise trade balance (USD bn)	-673	-753	-797	-843	-910
Federal budget balance (USD bn)	-532	-586	-666	-825	-935
percent of GDP	-3.7	-3.1	-3.4	-4.1	-4.5
Housing starts (mn)	1.27	1.18	1.21	1.25	1.30
Motor vehicle sales (mn)	15.5	17.5	17.1	17.4	17.3
Industrial production	0.7	-1.2	1.8	2.3	1.1
WTI oil (USD/bbl)	63	43	51	57	60
Nymex natural gas (USD/mmbtu)	4.94	2.55	3.02	2.95	2.95

Sources: Scotiabank Economics, BEA, BLS, Bloomberg.

which had lagged the broadly-based industrial recovery over the past year due to high inventories on dealer lots. However, these bloated inventories have been cleared by the acceleration in US new car and light truck sales since September, setting the stage for US vehicle production to increase to an annualized 11.4 mn units in the opening months of 2018, nearly one million units above the five-year low set between July and September 2017.

Chart 5



Sources: Scotiabank Economics, BEA.

BUSINESS INVESTMENT BECOMES A GROWTH DRIVER

US business investment is also beginning to 'fire on all cylinders', and is set to become an increasingly important driver of industrial activity, due in part to the recent US federal corporate tax overhaul which provides more positive treatment of capital equipment expenditures (chart 5). However, core capital goods orders, a proxy for business investment, had already begun to rev up before tax reform was passed. US core capital goods orders jumped 5% y/y January through November, the largest increase in more than five years. While the gain in capital goods orders has been driven mainly by a 60% y/y surge in demand for machinery from the oil and gas and mining sectors, demand is also reviving in other sectors as operating rates have climbed to cycle highs. For example, capacity utilization across US manufacturing plants is now at the highest level since mid-2008. The capital intensive high -tech sector has the highest capital utilization rate, with computer and peripheral equipment manufacturers operating at 95% of capacity, following a 12% y/y surge in output over the past year. Tightening operating rates are likely to lead to a double-digit increase in capital expenditures by high-tech companies over the coming year. However, even excluding high-tech, manufacturing operating rates have jumped 1.5 percentage points over the past year, the largest increase since mid-2014, which provides a positive backdrop for further gains in business investment.

AN ALTERED FISCAL PROFILE

The recently legislated federal tax reform under the *Tax Cuts & Jobs Act*, most of which took effect on January 1, is likely to have a number of both intended and unintended consequences. First and foremost, the planned tax-rate reductions are costly. They imply, when combined with our assumption of moderate aggregate federal spending increases to extend the temporary budget deal beyond January 19, that the federal deficit can be expected to widen from USD 666 bn in fiscal 2017 to USD 825 bn in fiscal 2018 and onward to USD 935 bn in fiscal 2019 (table 2). These projections are necessarily preliminary until details of the new tax framework are articulated. The anticipated rise in the federal deficit from a low of 2.4% of GDP in fiscal 2015 to a projected 4.5% of GDP in fiscal 2019 is expected to push federal debt held by the public from just over 35% of GDP in September 2007 to over 79% of GDP by September 2019, its highest level since 1948.

Across all three levels of government, the forecast contribution of current and capital spending to overall GDP growth remains a muted 0.1 percentage points annually. State and municipal administrations have become increasingly cautious with their budget plans as debate continues over the Republicans' wish to devolve more program spending responsibilities from Washington, DC to lower levels of government. Those sub-national governments with income-tax systems linked to federal definitions of personal and corporate taxable income have the option to fully or partially decouple their tax levies to maintain revenue flows and manage deficits. For relatively high-tax State governments, such as those in California, New York and New Jersey, the introduction of a federal USD 10,000 cap on the state and local tax deduction further constrains their options. Overall, we expect States and local governments to take actions that offset some of the stimulus provided in the short-term by the federal tax cuts.

GOODS TRADE DEFICIT WILL CONTINUE TO EXPAND

We anticipate US import growth to outpace exports in 2018 for the fifth consecutive year. Following Congressional approval of the tax reform package in December, US firms are likely to increase their purchases of foreign machinery and similar industrial products in order to expand production domestically, with capacity utilization in the manufacturing sector at its highest point since mid-2008. At the same time, business confidence in the sector is at cycle highs. An upbeat economic outlook even prior to the passage of the tax bill lifted machinery imports by 12% y/y on average from January to November 2017. As the US economy approaches full employment, household consumption will be supported by strengthening wage growth; demand for foreign goods should remain strong throughout 2018 owing to direct purchases and indirect demand through the manufacturing sector.

In turn, increasing global expenses in capital goods augur well for a further expansion in US exports in the near future, but not quickly enough to stem a widening in the US current account deficit from 2% of GDP toward mid-2% levels near the end of 2019 (chart 6). In dollar terms, a measure more closely watched by the US administration, the country's quarterly merchandise trade deficit, which sat at USD 781 bn in Q3-2017, appears on track within the next year or so to reach its highest level since Q2-2008, when it hit USD 882 bn.

FOREIGN FINANCING HEADING HIGHER

Mirroring the US's wider fiscal and trade deficits, the balance of payment's financial (i.e., capital) account surplus is set to grow further owing to greater reliance on foreign financing. This coincides with a recent return of foreign buyers to US securities markets (chart 7).

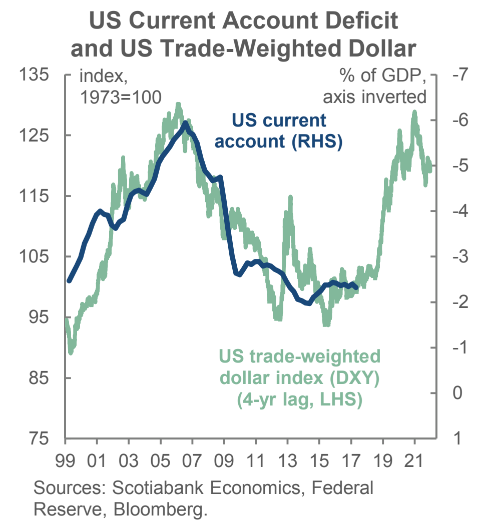
Net international purchases of US Treasuries (USTs) bounced back in 2017 from their September 2016 trough, notably lifted by sales to foreign official institutions as China increased its holdings of USTs after a massive drawdown in the second half of 2016 to soften a steep drop in the yuan (chart 8). Total foreign holdings of USTs by official and non-official accounts have remained relatively steady at around the USD 6 tn mark since early 2013, though once China and Belgium (owing to China's custodial accounts domiciled there) are excluded, UST holdings by other countries maintained a consistent upward trajectory over most of the last 5 years.

During the next several years, US Treasury issuance is set to increase in order to fund wider fiscal deficits arising from potential increases in entitlement outlays—mainly Social Security, Medicare and Medicaid—at the same time that federal revenues are set to decrease owing to the recent tax reform. As mentioned previously, we expect the federal deficit to widen from USD 666 bn in fiscal 2017 to USD 935 bn in fiscal 2019. The necessary increase in debt issuance, combined with an unwinding of the Fed's balance sheet, points to a swelling of the secondary UST market that will likely require even more participation by international buyers—just as larger financial account inflows in the balance of payments are needed to offset widening trade deficits.

RISKS REMAIN POLITICAL

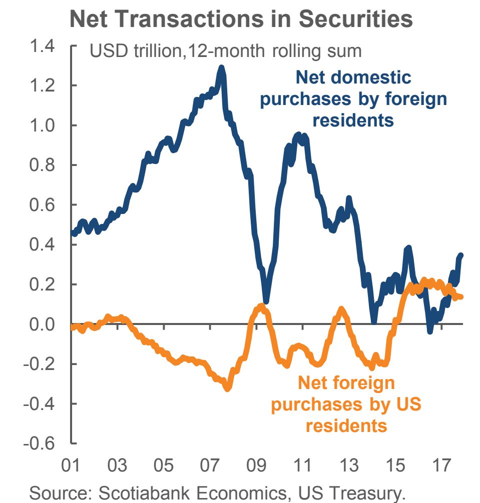
As global growth continues to synchronize and strengthen, fundamental support for further upside to the US economy is offset mainly by political risks at home and abroad. While a government shutdown should be avoided on January 19 with another short-term extension of federal spending authorizations, this would still leave a number of points of debate, such as the debt ceiling, unresolved. Additionally, the federal tax package combined with reduced domestic saving and a US dollar that remains relatively strong put the country on track to record ever-wider international trade deficits just as the NAFTA negotiations are reaching their climax. This could increase the chances of temporary disruption in the talks. Though access to the US market would likely remain unchanged until an agreement is reached on renegotiating and modernizing the pact, trade-intensive equities and currency markets would bear the brunt of any temporary uncertainty. However, concerns that the US could also withdraw from the WTO appear overblown: some 60% of the value of US exports rely on the preferential access to other markets provided by the most-favoured nation (MFN) tariffs that are accorded to WTO members.

Chart 6



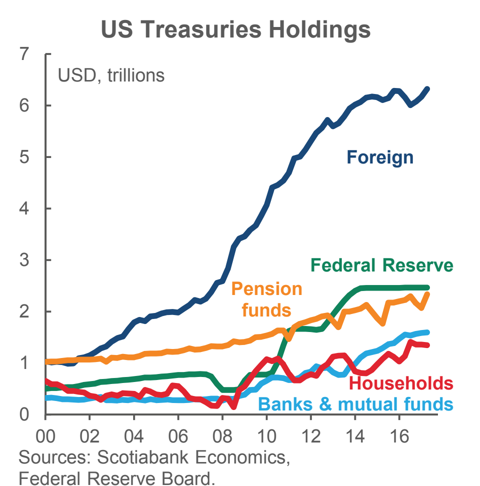
Sources: Scotiabank Economics, Federal Reserve, Bloomberg.

Chart 7



Source: Scotiabank Economics, US Treasury.

Chart 8



Sources: Scotiabank Economics, Federal Reserve Board.

US & Canadian Monetary Policy & Capital Markets

Scotiabank Economics has brought forward the timing of the next rate hikes by the Bank of Canada and Federal Reserve to this month and March respectively. Both countries' yield curves are forecast to further bear flatten on additional front-end policy tightening and limits to a bond market sell-off (charts 1 & 2, table 1).

BANK OF CANADA—TRUST, BUT VERIFY

We forecast three increases in the Bank of Canada's overnight lending rate this year followed by three more hikes in 2019 at which point the terminal, neutral policy rate of 2.5% will be achieved well below our estimate of a traditional 'Taylor rule' approach. This policy rate view suggests that the Canada 2 year yield will rise to just over 2½% over this period.

Our forecast for continued monetary policy tightening by the BoC is rooted in cyclical considerations that position Canada at an advanced stage of global monetary policy dynamics. Governor Poloz has said he was going to let the economy run hot but a) it arguably is now and b) we took the remark to inform a 'cautious' profile rather than as a barrier to near-term hikes. That said, we are cognizant of the risks to NAFTA and global trading relationships but accept the argument that this risk could overhang the Canadian economy for months, quarters or years and that there is a limit to how long monetary policy can be put on hold as the economy faces accelerating wage and price pressures amid capacity constraints. Trusting a base case outlook to be verified by data dependence is a prudent balancing approach to managing policy risks. It is conceivable that falling behind building wage and price pressures is a bigger risk to Canada than NAFTA uncertainty.

Indeed, very strong hiring, a recent surge of capital goods imports and resilient business attitudes with a hawkish tinge (here) run counter to any impression that the Canadian economy is already paying a price for NAFTA uncertainty or that it is being offset by domestic economic strengths. When NAFTA negotiations skidded into the ditch from October onward, business attitudes only strengthened (chart 3). Obviously this risk could heat up at a moment's notice and drive easier monetary policy than forecast, but until we know otherwise, we place a premium upon the following evidence as drivers of our policy rate view.

- The output gap is shut and Canada risks slipping into excess aggregate demand by the average of the BoC's two main measures (chart 4).
- Industrial capacity utilization is running at a ten year high of 85% and eight points above the US. Many industries are at cycle peaks. This buttresses evidence from output gaps and leaves companies with the choice to expand capacity or gently raise prices — or probably both.
- Core CPI has been trending higher from 1.3% y/y at the low point in May to 1.7% now using the average of the BoC's three measures (chart 5). There has been more inflation traction in Canada than in the US.

CONTACTS

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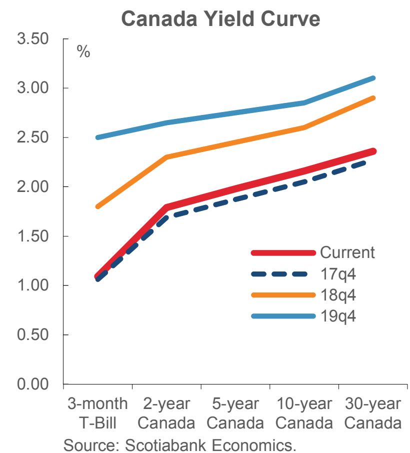
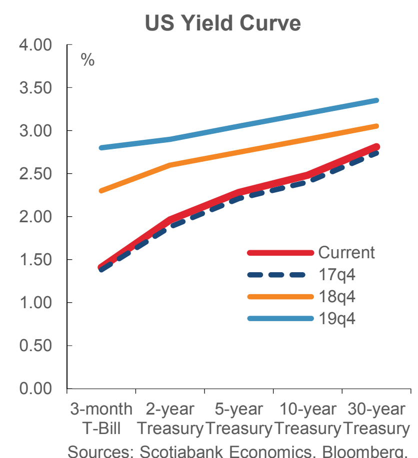
Chart 1



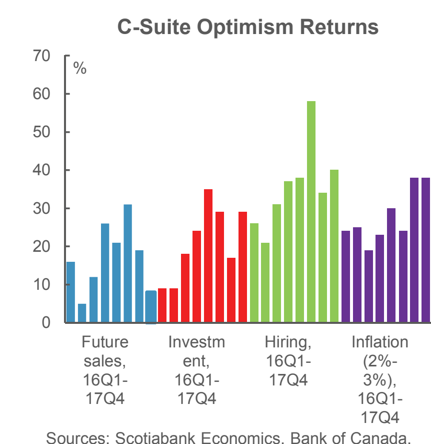
Source: Scotiabank Economics.

Chart 2



Sources: Scotiabank Economics, Bloomberg.

Chart 3



Sources: Scotiabank Economics, Bank of Canada.

- Scotiabank's René Lalonde's model for core inflation projects a return to the 2% mid-point of the 1–3% inflation target range in early 2019 while incorporating our policy outlook. In that context, it is conceivable that monetary policy actions that operate with a 12–18 month lagged influence are already behind the curve, but not egregiously so. Further, there are idiosyncratic influences upon inflation that have been unique to Canada and that are lifting, including electricity price cuts and auto prices.

- Wage pressures are building. The BoC's preferred measure for permanent employees has risen from a low of 0.5% y/y in April to 2.9% now and is soon headed to the 3.5–4% range (chart 6).

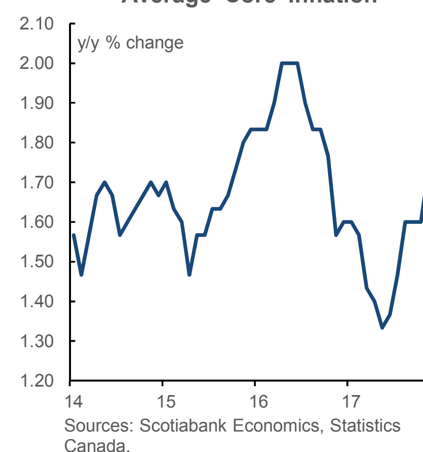
- Tremendous job gains, a sharp rise in hours worked and rising wages mean that personal disposable income growth is strong and we expect about 4% quarterly annualized growth over 2018.

- A brief respite in Q3 of last year caused some concern that consumers were retrenching after three quarters of 8% annualized gains in retail sales volumes. Early evidence on Q4 indicates the return to about 4% growth in retail volumes as income gains take over from child benefit payments to drive consumption. If about 60% of the economy that is represented by consumer spending is holding up well then that is a significant offset to other risks.

Chart 4

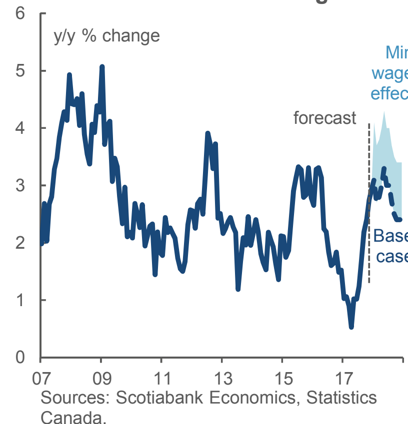
Sources: Scotiabank Economics, Bank of Canada.

Chart 5



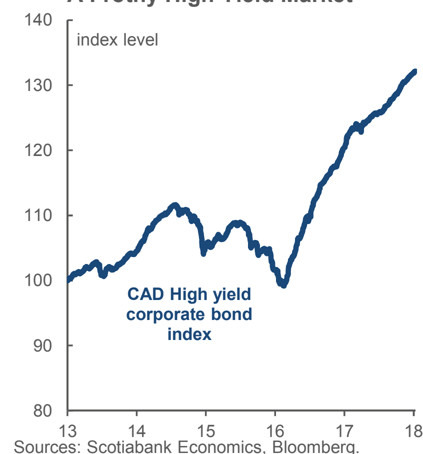
Sources: Scotiabank Economics, Statistics Canada.

Chart 6



Sources: Scotiabank Economics, Statistics Canada.

Chart 7



Sources: Scotiabank Economics, Bloomberg.

- Commodity prices continue to recover, though unevenly, and that benefits national income with positive implications for corporate profits, fiscal revenues and household incomes. In USD terms that guide many resource firms in Canada, WTI and Brent crude prices are 20–25% higher than a year ago. East coast projects sell at Brent and the discount to WTI on Western Canada Select should compress when Keystone becomes fully operational around decade's end. Gold is up 11% y/y and base metals ranging from aluminum to nickel, zinc and copper are up by about 25%. Agricultural commodities are not experiencing much price appreciation in grains but North American livestock prices are materially firmer.

- Most of the rise in the currency to date is explained by solid fundamentals and higher commodity prices. At the margin, the currency's appreciation to the 1.25 USDCAD range imposes little incremental tightening on the economy at a time when financial conditions need to tighten by more. The entire point to tightening monetary policy and its influences upon rates and the currency is to cool growth to a more sustainable pace in the context of material and rising capacity pressures.

- Financial stability considerations indicate room for tightening policy. House prices are more resilient than some feared and credit growth remains solid. Spreads between mortgage bonds and Government of Canada bond yields are tight as are provincial government bond spreads while the high yield market has strongly recovered from the commodity shock and returned to elevated heights (chart 7).

Sundry risks overhang the outlook for the Bank of Canada but we judge those risks either as reason to tread carefully in terms of monetary policy signals (eg. the impact of B20 OSFI mortgage stress testing guidelines) or as patient debates (e.g. NAFTA) or as risks that have thus far not materialized despite perennial fears (eg. a large negative imported bond market shock). On balance, risks to the outlook will inform future steps but we're comfortable with our current assessment to advise continued policy tightening.

FEDERAL RESERVE—PLENTY LEFT IN THE TANK FOR RATE HIKES

We forecast three rate hikes by the Federal Reserve this year and two more next year at which point a terminal neutral rate of 2.75%% will be reached. This is consistent with our belief that the real neutral policy rate lies under 1%.

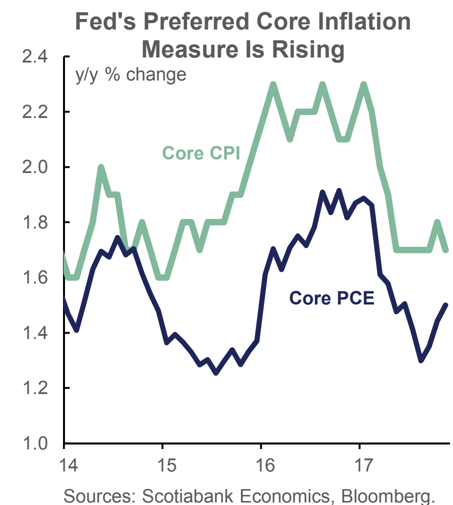
The downside surprise to inflation in 2017 is already turning around and shaking off USD and idiosyncratic influences. There is nascent evidence that the Fed's preferred measure of core PCE inflation is rising from its low point (chart 8). That is not evident in core CPI but the Fed prefers core PCE inflation for good reasons. One is that it dynamically adjusts for changes in consumer behaviour as spending patterns change compared to the fixed weights used in CPI. Another is because PCE captures important components more completely. An example is medical care costs. This matters more and more over time, with medical care spending now accounting for a record high 17% of consumer spending as medical care prices firm slightly.

Diminishing spare capacity leans toward further gradual inflationary pressures. Measures of the US output gap have generally shut (chart 9). Inflation behaves stubbornly and with variable lags in both directions at turning points but the elimination of slack points to one argument in favour of firming price pressures.

A further argument involves the currency's role. This speech by former Vice Chairman Stanley Fischer about two years ago is still instructive to how the Fed generally views the dollar's influence. Fischer stated that Fed models estimate that for every 10% trade-weighted appreciation in the dollar, core PCE inflation is reduced by 0.5% in the two quarters following the dollar's move and the four-quarter effect is to reduce core PCE inflation by about 0.3%. From the Spring of 2016 until the end of that year following the US election results, the broad dollar index had risen by almost 10% and therefore this factor could have easily explained most of the deceleration in core PCE inflation from 1.9% y/y in late 2016 to 1.3% y/y this past August. Since late 2016, however, the broad dollar index has depreciated by over 8% (chart 10). If core PCE inflation responds symmetrically to USD softness, then core PCE inflation could soon rise closer to the Fed's 2% target.

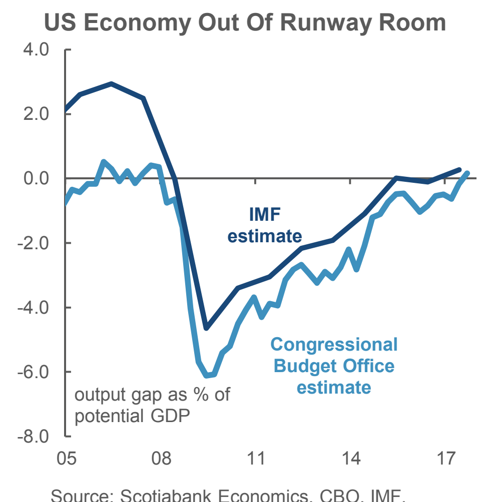
But should the Fed not hike or do so with great trepidation due to late cycle considerations? On this, we advise being careful toward selective use of the evidence. Before turning to this, note the haughty assumption behind some forecasters' beliefs in that they warn of recession risk but foresee the Fed hiking into it which assumes the forecaster is infinitely smarter than the Fed! On the cycle evidence some variables indicate late cycle pressures, like consumer confidence, the unemployment rate and stock market valuations. History, however, shows that factors like low unemployment rates can persist for long periods without signalling imminent recession risks.

Chart 8



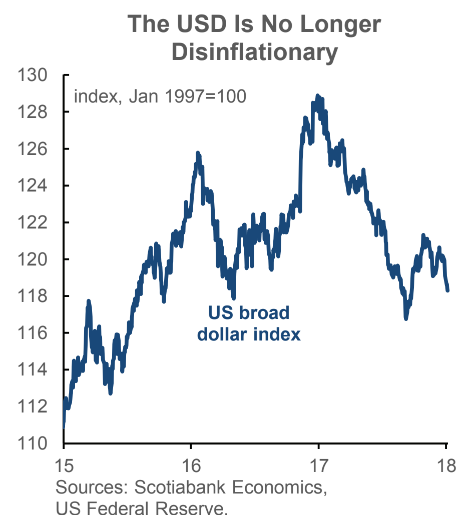
Sources: Scotiabank Economics, Bloomberg.

Chart 9



Source: Scotiabank Economics, CBO, IMF.

Chart 10



Sources: Scotiabank Economics, US Federal Reserve.

Furthermore, financial market indicators are mixed. The slope of the yield curve (chart 11) was comparably flat in the US through much of the 1990s without preceding imminent recession over the decade and even so at times in the 1980s and it took a few years before the signal was followed by the GFC. The NY Fed's probability of recession model based upon the slope of the curve (here) indicates a low 11% chance of recession. In any event, when curve slope works as a sign of impending recession, the evidence is usually showing up through a greater variety of readings than at present.

Other indicators, however, suggest mid- if not early-cycle influences. For instance, the household debt service burden is not showing any signs of classic late cycle pressure and lies toward the bottom end of the past four decades (chart 12). It's usually when consumers are over-extended that recessions spring up. The absence of household leverage and its effects upon stretched debt payments is in part a function of regulatory policy and the aftermath of the crisis but it still has room to move higher and higher borrowing costs will gently do so.

Also consider that the output gap is shut, but not yet tripping into material excess aggregate demand as it often has at late stages of past cycles. Fairly tepid real wage and price pressures add to evidence against impending recession risk. Tighter monetary policy is needed to head off overheating risks, but said risks are modest at this juncture.

Then consider corporate balance sheets. This piece by the Federal Reserve incorporates the Fed's 'dot plot' guidance on future rate hikes into projections for corporate interest coverage and concludes they would have a minimal effect upon a starting position of strength that belies past cycle-cycle pressures. The corporate debt-to-equity ratio is fairly low but can be misleading and sensitive to valuation effects which is one reason to prefer interest coverage in addition to its predictive powers applied to financial distress. On that note, recall the US corporate debt:equity ratio was comparably low just before the crisis and banks were thought to be well capitalized. Interest coverage is a more reliable gauge of stress and shock risk. By comparison, coverage was already waning 2–3 years before the global financial crisis when profit growth began to turn south and there are no such signs of that at this point especially after smoothing through a well understood transitory near-term shock owing to tax reforms before future earnings seasons benefit.

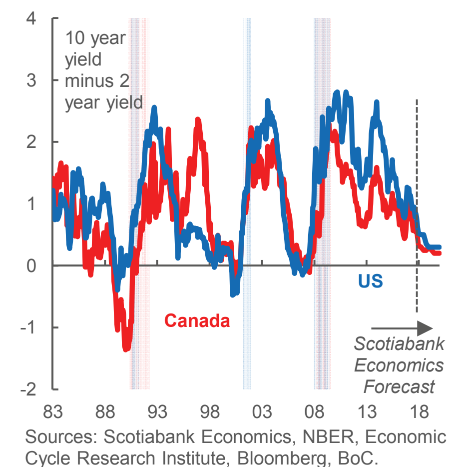
Unconventional balance sheet management policy by the Federal Reserve is expected to remain on auto-pilot this year. The plan has been well telegraphed since July and moves toward allowing US$50 billion per month to roll off the balance sheet by October subject to each months' available securities for reinvestment (chart 13).

FLATTER, BUT NOT INVERTED CURVES

The 2s10s curves are expected to further bear flatten in Canada and the US but not invert over our 2018–19 forecast horizon (see charts 1, 2 and table 1 again). We do not anticipate a recession and wouldn't view curve inversion in today's policy repressed market as a clear-cut recession signal anyway.

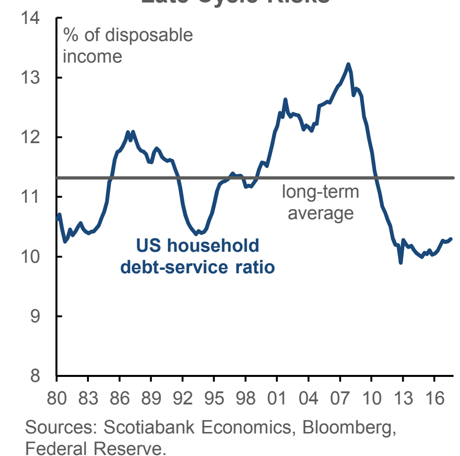
[1] Implied earnings growth (G) = ((R * P/E) - (DY * P/E)) / ((P/E + (DY * P/E)) where R is the required return, P/E is the price-earnings ratio, DY is the dividend yield.

Chart 11



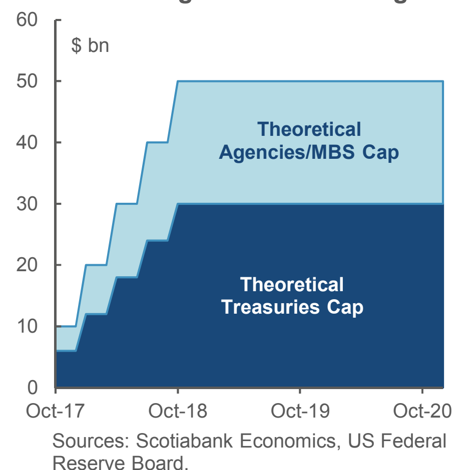
Sources: Scotiabank Economics, NBER, Economic Cycle Research Institute, Bloomberg, BoC.

Chart 12



Sources: Scotiabank Economics, Bloomberg, Federal Reserve.

Chart 13



Sources: Scotiabank Economics, US Federal Reserve Board.

While we apply modelling efforts as a guide to the forecasting parameters, many of the complex multitude of influences upon the bond market are outside of the scope of modelling efforts and an obvious challenge to even the most experienced investors. Our contribution to the debate is to highlight the major considerations overhanging bond market forecasts as discussed below. We caution that the high uncertainty around their net influences upon a bond yield forecast should have clients making use of wide brackets in scenario analysis rather than hanging upon point estimates in time. On net, I think our broad curve views lean toward being fairly aggressive in both countries in the nearer term.

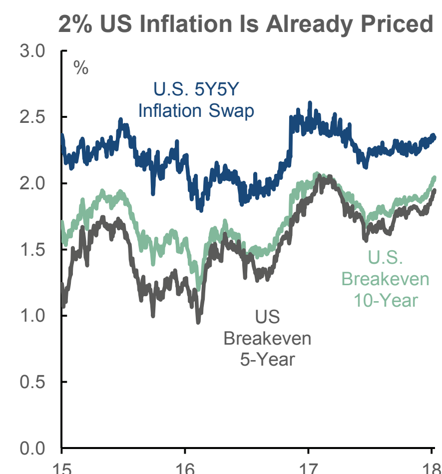
1. **Inflation:** Market-based measures are generally in line with a stable longer run inflation rate of around 2% (chart 14). More of our forecast rise in US PCE inflation and Canadian CPI inflation is expected to influence short-term policy rates rather than longer term nominal bond yields. The inflation trading market is braced for higher expected inflation readings but is sensitive to upside and downside risks, but real implied yields are depressed for other reasons.

2. **Risk aversion:** It is prudent to continue to caution against historically elevated stock market valuations (chart 15), but not to do so stridently. Even absent a stock market correction, portfolio rebalancing may continue to support sovereign debt instruments and retain appetite for safe-haven assets within diversified portfolios. Deriving an implied earnings growth rate from equity valuation methods such as a modified Gordon model[1] or price-to-book calculations is complicated by the fact that not all of the necessary ingredients are observable; indeed key inputs like required return must be estimated which in turn introduces uncertainty toward today's equity risk premium. It is therefore difficult to determine with full conviction that equities are over-valued and, even if so, to what degree. For instance, if the required return is abnormally low then the hurdle for satisfactory earnings growth may be commensurately low.

3. **Policy rate influences upon global carry:** The central banks in Anglo-American economies are forecast to remain in tightening mode, particularly in the US and Canada. The outlook for other major central banks' policy rates is comparatively sanguine (chart 16). Zero or negative policy rates are generally expected to hold at the ECB and BoJ. Informing this view is that Japan is expected to make little headway on its 2% inflation target, Governor Kuroda will be reappointed to another term, and there is the risk of policy easing to prepare for an expected sales tax increase next year. Also informing this view is that if Euro strength continues to restrain 'supercore' inflation readings around 1% y/y then we don't rule out prolonged stimulus measures in altered format to account for limits to ECB bond buying and figure President Draghi has plenty of tools to employ if needed. By corollary, this assumption of little policy rate risk outside of Anglo-American economies limits the potential for a rise in term premia in JGBs and EGBs. By further corollary, this may limit the extent to which other sovereign bond markets can sell off, including Treasuries, without inducing arbitrage through currency hedged carry trades.

4. **Unwinding quantitative easing:** Reports of the death of global central bank bond buying and shrinking balance sheets are highly premature. Only the Fed's balance sheet is projected to dwindle over our forecast horizon and this is information that is already known to the market through the Fed's well communicated reinvestment

Chart 14

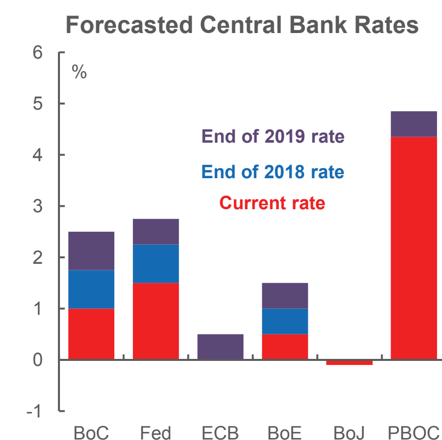


Source: Scotiabank Economics, Bloomberg.

Chart 15

Sources: Scotiabank Economics, Robert Shiller.

Chart 16



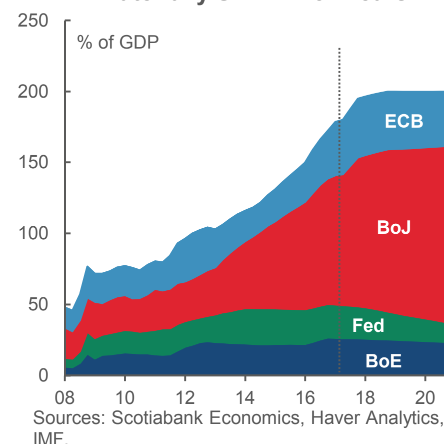
Sources: Scotiabank Economics, BoC, Fed, ECB, BoC, BoJ, CSIC.

plans (chart 17). The BoJ's reduced buying is often misinterpreted as a signal of waning policy resolve without controlling for the substitution toward an 'around 0%" nominal 10 year JGB yield target that introduces a credible threat against short sellers. I don't see that target changing at all, and not materially if at all. The ECB's buying has been reduced to the €30 billion per month pace this year until at least next September. Limits to further bond buying posed by the capital key and various limits to altering it probably mean incremental buying is coming to a close later this year or soon thereafter. A prolonged period of balance sheet reinvestment is then likely as the ECB probably follows the Fed's playbook of reducing reinvestment and then eliminating it only when policy rate normalization is well underway through a series of rate hikes. We don't expect this reinvestment change to occur until late decade at the earliest.

5. **The global saving–investment imbalance:** The imbalances that drove a glut of global savings have been cited as a factor behind low bond yields over the pre- and post-crisis era (like here). In the lead-up to the crisis, the current account surpluses of emerging markets resulted in exporting hoarded capital to countries like the US and played a major role in the excesses of US financial markets at the time, including China's buying of what turned out to be low quality mortgage instruments. Insofar as the US Treasury market's connection with the rest of the world is concerned today, said imbalances stopped improving in the immediate aftermath of the crisis and have since worsened. To fund a US current account deficit that is at its widest of the post-crisis era (chart 18), the US remains dependent upon large capital account inflows from the rest of the world. More of that inflow today, however, is derived from large capital account surpluses of other advanced economies—notably the Euro-area and particularly Germany, plus Japan. This effect should reinforce the carry trade's appetite for US financial instruments including Treasuries. A key risk, however, is that if the US turns more protectionist against China despite the decline of China's current account surpluses from 10% of its economy a decade ago to 1% today, then by corollary any damage to China's trade position translates into lower net foreign currency receipts and hence less to invest abroad including in US Treasuries. There is, however, a limit to this logic in that any selling by China would impair the value of its own US$1.25 trillion worth of Treasury holdings that have risen by about US$140 billion over the past year. Canada also has relatively wide current account deficits versus pre-crisis surpluses. Also note that the sum total of the past decade's realignment of global savings has parked over US$11 trillion in global foreign exchange reserves which is more than five times the Fed's SOMA Treasury holdings and about 70% higher than at the end of 2008. This stockpiled saving lends great market power to the nations where such savings are concentrated including China, Japan, about ten others with reserves in excess of US$200 billion and other countries with smaller balances.

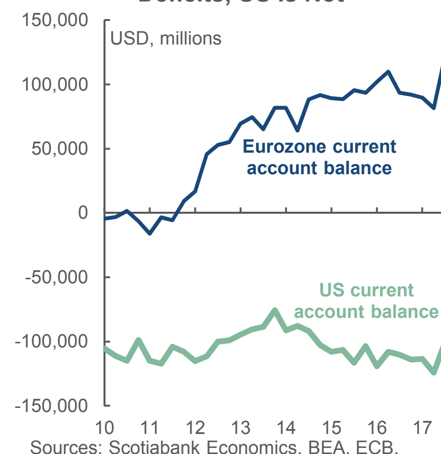
6. **Neutral policy rates:** Our estimates of the long-run potential growth rates of major advanced economies that tend to have the largest debt issuance markets has not materially changed over recent forecast updates. What we see in the US by way of tax reforms, for instance, does little to nothing positive to long-run growth. Somewhat by extension, our estimates for neutral policy rates also have not materially changed. We think both the US and Canadian neutral policy rates lie somewhere in the +/- 2.5% range. Neutral policy rate estimates plus term premia assumptions anchor the curve's pricing of potential future Fed rate policy actions.

Chart 17



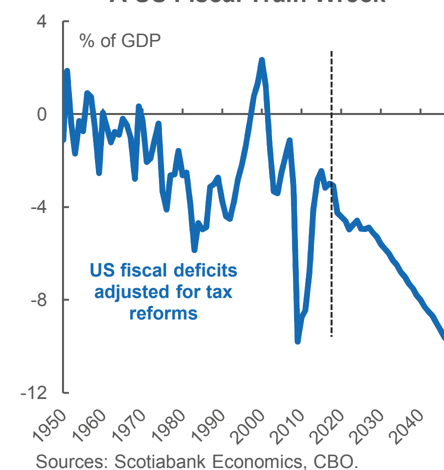
Sources: Scotiabank Economics, Haver Analytics, IMF.

Chart 18



Sources: Scotiabank Economics, BEA, ECB.

Chart 19



Sources: Scotiabank Economics, CBO.

7. **Fiscal policy:** The US was already on a path toward high and rising fiscal deficits before the introduction of limited tax reforms. Unfunded social security obligations and health care expenditures were a major part of the concern. Adding an extra US$1.5 trillion to cumulative deficits over the next decade further erodes the deficit outlook to what is shown in chart 19. The impact of deficits on bond yields is controversial and uncertain. For instance, the large deficits of the post-crisis era had little to no effect on bond yields because of other influences like safe-haven appetite and central bank policies. Most economists still subscribe to a long-run positive effect of deficits on bond yields but the estimates are all over the map. Two pre-crisis studies of the effects before other influences came to light (here and here) posited that every one percentage point rise in the deficit to GDP ratio could, over time, raise longer term bond yields by 20–60bps. If the deficit projections remain generally intact as the long-run influence of other considerations such as central bank policies abate, then the future may bring to light a very negative bond market outlook given the magnitude of the forecast deterioration in US deficits.

8. **Term premium:** Research (here) suggests US 10 year Treasury yields are about 1% lower than where they would be otherwise in the absence of the Fed's balance sheet expansion and controlling for other influences. We don't expect this term premium to be suddenly restored as the Federal Reserve eliminates reinvestment and allows its balance sheet to begin to contract later next year and rely upon many of the other points provided in this section to inform this bias.

9. **Cycle maturity:** By April, this will be the second longest expansion on record. By early next year, continued growth would make the current cycle the longest in US history. Uncertainty over whether recession lurks is likely to retain appetites for safehavens like sovereign debt of mature economies. We think this risk is nevertheless often exaggerated. Not all major variables are suggesting late cycle risks. For instance, US household debt payments as a share of income sit at their lowest in three and a half decades and nominal wage growth looks mid-cycle at best to us. In that context, aided by wealth effects and limited albeit regressive tax reforms, US consumers could well have plenty left in the tank to drive future spending growth.

10. **Pensions and life cos:** It's not all about central banks. In fact pensions were a significant source of buying over 2017H2 partly to rebalance portfolios amid equity gains. Private and public pensions own over US$2¼ trillion worth of Treasuries and our belief is that a rise in US 10s to the 3% mark would bring forward aggressive buying to lock in returns for servicing pensioners.

Table 1

Scotiabank Economics' Canada-US Yield Curve Forecast

	2017	2018				2019			
					(end of quarter, %)				
Canada	**Q4**	**Q1f**	**Q2f**	**Q3f**	**Q4f**	**Q1f**	**Q2f**	**Q3f**	**Q4f**
BoC Overnight Target Rate	1.00	1.25	1.50	1.50	1.75	2.00	2.25	2.25	2.50
Prime Rate	3.20	3.45	3.70	3.70	3.95	4.20	4.45	4.45	4.70
3-month T-bill	1.06	1.30	1.55	1.55	1.80	2.05	2.30	2.30	2.50
2-year Canada	1.69	1.90	2.05	2.20	2.30	2.40	2.50	2.55	2.65
5-year Canada	1.87	2.05	2.15	2.30	2.45	2.55	2.60	2.65	2.75
10-year Canada	2.05	2.20	2.30	2.45	2.60	2.65	2.70	2.75	2.85
30-year Canada	2.27	2.35	2.50	2.75	2.90	3.00	3.10	3.15	3.10
United States	**Q4f**	**Q1f**	**Q2f**	**Q3f**	**Q4f**	**Q1f**	**Q2f**	**Q3f**	**Q4f**
Fed Funds Target Rate	1.50	1.75	1.75	2.00	2.25	2.25	2.50	2.50	2.75
Prime Rate	4.50	4.75	4.75	5.00	5.25	5.25	5.50	5.50	5.75
3-month T-bill	1.38	1.80	1.80	2.05	2.30	2.30	2.55	2.60	2.80
2-year Treasury	1.88	2.20	2.30	2.50	2.60	2.70	2.75	2.85	2.90
5-year Treasury	2.21	2.50	2.60	2.70	2.75	2.85	2.90	3.00	3.05
10-year Treasury	2.40	2.70	2.80	2.85	2.90	3.00	3.05	3.15	3.20
30-year Treasury	2.74	2.85	2.95	3.00	3.05	3.15	3.20	3.30	3.35

Sources: Scotiabank Economics, Bloomberg.

Mexico

STRONGER GROWTH IN 2018, BUT MANY RISKS

- **Mexico is facing a challenging year on the economic and political fronts. The range of possible outcomes is very wide, due to the conjunction of several factors that could tip the balance either way. Our base scenario is still a gradual improvement in the pace of growth. However, the heightened uncertainty will likely be a heavier burden for the economy, so we are moderately adjusting our growth forecast.**

The road ahead for the Mexican economy is somewhat foggy. A number of factors of great relevance could influence the course of the economy, either positively or negatively. These include the NAFTA renegotiations, the potential impact of US tax reform, normalization of monetary policy in the US, inflation dynamics in Mexico, the evolution of the situation in North Korea and, of course, Mexican elections. As a result and now as a habit, there is a high level of uncertainty surrounding the macroeconomic forecasts for the year.

Our base case scenario remains a modest improvement in the pace of growth in 2018, but from a lower starting point in 2017, reflecting historical revisions to the national accounts. The latest data presents mixed signals. On one hand, exports are booming due to the recovery in oil prices and strong US auto sales. Export-related manufacturing industries are also booming, employment numbers continue to show strong job creation coupled with low unemployment rates, private consumption remain relatively strong, and banking credit keeps growing at healthy rates. On the other hand, retail sales are faltering while domestic auto sales are falling, construction is now contracting while mining keeps falling sharply and investment remains severely affected. It seems that households and firms are doing well but are not immune to the many unknowns that the outlook presents, so we anticipate cautious behaviour during 2018.

Under these circumstances, we are reducing our GDP growth forecast for 2017 to 2.1% from 2.4% in the previous *Global Outlook*, and for 2018, to 2.4% from 2.7%. By sectors, the industrial production is expected to grow 1.9% in 2018, mining will fall 2.4% and construction should expand by 1.7%. Manufacturing activity will remain healthy, rising by 3.4%.

We forecast that private consumption will improve marginally as households have already absorbed the shocks of 2017, such as the higher inflation, interest rates and the natural disasters of September. As is usual in election years, some consumption-inducing spending is anticipated. Investment is expected to recover, although at a modest rate, as public sector capital spending stops falling, and firms digest the adjustments of 2017 and look again towards the positive medium and long term perspectives.

On the monetary policy front, the reference rate is expected to increase another 25 basis in the last quarter of the year, ending at 7.75%. This additional increase is required to keep pace with the Federal Reserve. Also relevant to this view are inflationary pressures that will likely continue through the year: even though we

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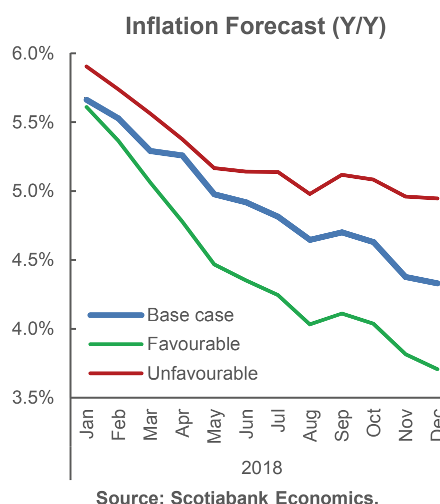
Chart 1



Source: Scotiabank Economics.

are anticipating a rapid descent on the year/year inflation rate, we think inflation will remain above the 4% threshold with upside risks to that view. In the chart, we present the base scenario for the general inflation along with alternatives built on arbitrary assumptions: a favourable scenario in which each month's inflation is the average of the last 7 years less 10% of standard deviation of this period; and an unfavourable scenario in which each month's inflation is the average of the mentioned period plus 40% of the standard deviation recorded. As can be seen, even in the favourable scenario, y/y inflation remains above the 4% threshold most of the year, and in the unfavourable scenario, y/y inflation remains stubbornly close to the 5% threshold. This exercise tells us that inflation will remain as a significant concern for Banco de Mexico most of the year.

The FX forecasts remain basically the same, with the Mexican peso (MXN) ending close to 19.48 per USD, but it should be noted that a high volatility in the currency is expected, reflecting the unusually high uncertainty levels around the economic environment. In this scenario, the MXN could temporarily fall below the 18.0 mark if markets price in a positive outcome of the NAFTA negotiations while disappointing progress on the negotiations could easily see the MXN go beyond 21. Another relevant driver for the MXN will be the expected outcome of the presidential election, adding pressure if a negative outcome is perceived and releasing tension if a positive outcome is anticipated.

There are many different possible outcomes for the Mexican economy in 2018. On the pessimistic side there could be a "perfect storm" if an unfortunate combination of factors occurs, such as a termination of NAFTA and the electoral process in Mexico becomes sour while domestic inflation rises. On the other hand, a more positive outcome would occur if tensions on the NAFTA renegotiation process are eased by a more constructive stance from the US Government, the US tax reform has a positive effect on US economic growth and this favours Mexican exports, inflation in Mexico descends rapidly, the electoral process runs smoothly and a positive outcome is anticipated. We should not forget that the structural reforms achieved should produce a positive additional impulse for the economy as time passes.

United Kingdom

- **We expect GDP growth to be on a rising trajectory during 2018.**
- **CPI and RPI inflation are likely to slow sharply this year, as the uplift from higher imported inflation on goods prices begins to unwind.**
- **Wage inflation is likely to be absolutely crucial in determining the likely timing of the next BoE rate hike.**

GROWTH: HAPPIER NEW YEAR?

UK GDP growth should be on an upwards sloping trajectory during 2018, largely reversing the slowdown recorded over the course of 2017. More specifically, growth has slowed from 2% y/y at the start of 2017 and we expect the Q4-2017 data to show just 1.4% y/y growth. We expect the pace to reaccelerate to 1.8% y/y by the end of 2018. So our emphasis is that 2018 will be a better year than 2017 since growth will be accelerating. However, our forecasts point to an annual average growth rate of 1.6% y/y for 2018, which would be a slight deceleration compared with 1¾% y/y for 2017. So growth will be both better and worse than last year, depending on how you look at it.

The main reason for the slowdown in growth last year and indeed the main reason we expect a turnaround this year is the consumer. Last year, sharply rising CPI inflation, set against stagnant wage inflation meant that household real disposable income growth ground to a halt. In turn, this caused consumer spending growth to decelerate. We expect the fundamentals to reverse during 2018. In particular, we expect inflation to slow sharply and wage inflation to accelerate. This should restore household real disposable income growth and drag consumer spending growth along with it (chart 1).

Consumer spending aside, Brexit is likely to continue to cast a shadow over some aspects of growth. Investment is likely to be the prime culprit, as firms and households hold back from big-ticket expenditure amid uncertainty about where the economy will be over the coming 18 months or so.

INFLATION: TOPPING OUT

We believe that inflation has peaked and there is likely to be a fairly abrupt deceleration over the coming year. The main reason to expect a slowdown is base effects as the uplift from imported inflation begins to unwind. Put differently, sharp increases a year ago in the prices of exchange-rate-sensitive goods are unlikely to be repeated—dragging the % y/y inflation rate lower. On top of this, we doubt that the near-12% increase in electricity bills during 2017 will be repeated. Combined, that should subtract 1 to 1¼% from overall inflation during 2018.

The acceleration in inflation during 2017 and the slowdown that we expect during 2018 are almost entirely associated with core goods—in turn linked closely to the exchange rate. Meanwhile core services inflation, which is a reflection of domestically generated price pressures, was broadly unchanged last year. We

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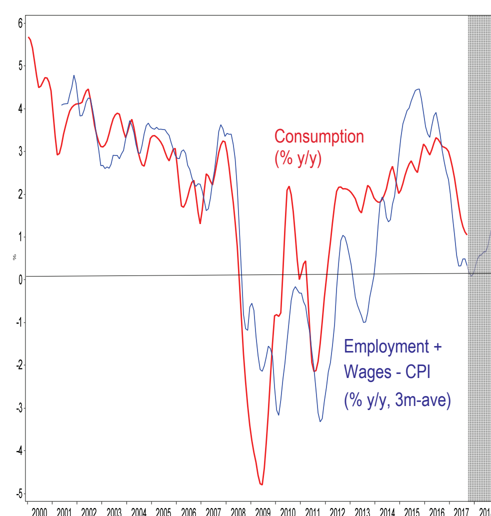
Chart 1

Household consumption vs proxy for real income growth



Sources: Macrobond, Scotiabank.

believe that the latter tends to take a steer from wage inflation. With pay growth likely to accelerate in 2018, we expect core services inflation to creep higher, though it may not be sufficient to offset the slowdown in overall inflation.

MONETARY POLICY

We believe that the Bank of England will be acutely sensitive to developments in wage inflation over the coming year. The logic is that higher wage inflation should lead to rising domestically generated inflation pressures. In turn, that would give the Monetary Policy Committee (MPC) justification to withdraw further monetary policy stimulus as soon as the May 2018 MPC meeting. Further ahead, if our view of accelerating GDP growth also comes good, a second rate hike at the November MPC meeting is plausible.

Eurozone

- **Eurozone GDP growth should continue onwards and upwards, consistent with robust survey indicators.**
- **Meanwhile, headline inflation is likely to slow to around 1% y/y in the near term, but gradually move higher thereafter.**
- **We expect the ECB to see its current QE programme through to completion in September, and leave the policy interest rate unchanged for at least another year thereafter.**

GROWTH: ONWARDS AND UPWARDS

Eurozone GDP growth is likely to continue to trend higher in line with the signals from survey indicators which have gone from strength to strength. More specifically, the survey indicators point to the quarterly growth rates approaching 1% q/q and the annual growth rate trending up towards 3½% y/y by mid-year (chart 1). If that materialises, that would be the fastest growth rate since 2007.

On a component-by-component basis, the upbeat outlook for eurozone is broad-based by category of expenditure. The prospects for fixed investment look very promising, particularly given the relationship with the manufacturing PMI survey (chart 2). That is especially encouraging since growth underpinned by robust investment is more likely to prove enduring. Consumer confidence is flying, standing at the highest since January 2001. In turn this points to further acceleration in household consumption growth. Net trade *should* be supportive amid encouraging signals for global growth, however, the more granular signals such as global trade volumes growth have been less impressive than might have been assumed.

By region, Germany is leading the charge (in terms of contributions to overall eurozone growth) and is already on the verge of breaking above 3% y/y. Spain isn't far behind, having grown in excess of 3% for 2½ years (though its smaller weight in overall eurozone GDP means its contribution is slightly behind Germany's).

Overall, we expect GDP growth to post expansion of 2¾% y/y during 2018 and fractionally lower in 2019. Those forecasts are a reasonable margin higher than the latest ECB staff projections, but we could easily have aimed even higher.

INFLATION

Having been fairly stable around 1½% y/y over recent months, inflation is likely to lose ground into the start of 2018 and could flirt with 1% y/y. In turn, that deceleration is likely to be largely due to unfavourable base effects (food and energy). Thereafter, core inflation is likely to be in the driving seat. Core inflation is currently running just below 1% y/y having briefly poked its head above 1% y/y in mid-2017. When charted against slack in the labour market, there appears to be a reasonable correlation, with the fall in unemployment in

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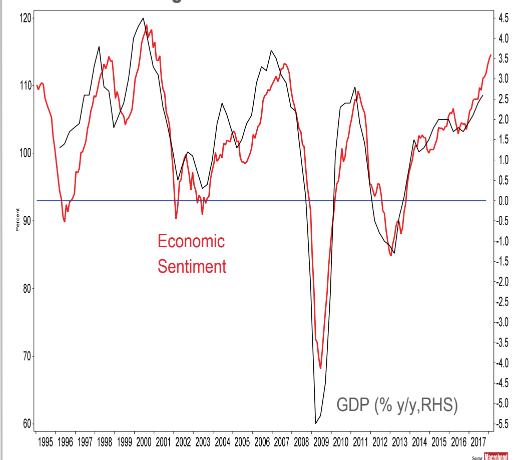
Chart 1

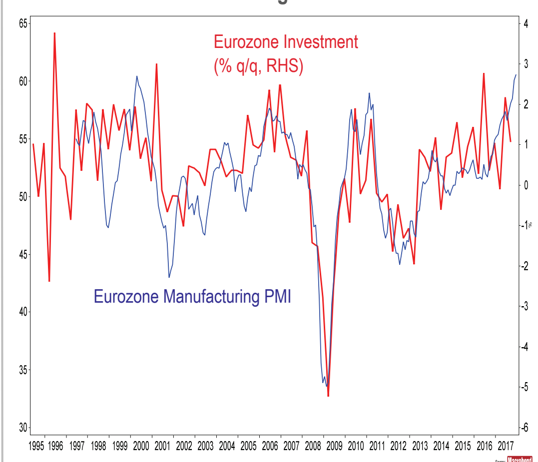
Eurozone GDP growth vs economic sentiment



Sources: Macrobond, Scotiabank.

Chart 2

Eurozone fixed investment growth vs PMI



Sources: Macrobond, Scotiabank.

recent years coming broadly in tandem with the mild upward drift in core inflation (chart 3).

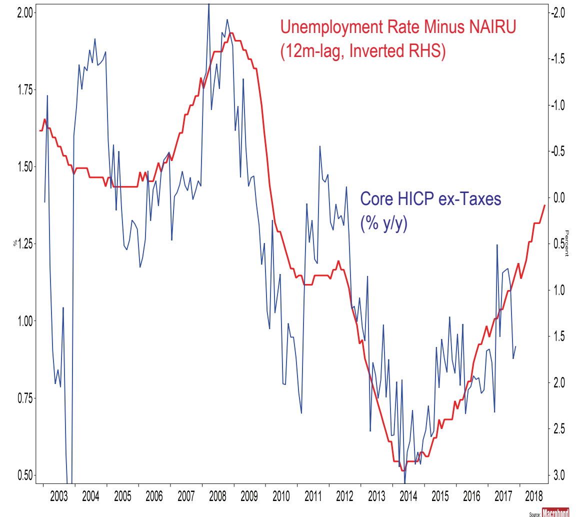
Given that relationship, core inflation *should* reside in the 1¼ to 1½% y/y ballpark by late 2018. However, the experience of the UK in the past year or two has shown that the linkage between the unemployment rate and underlying inflation has weakened. In turn, that has been explained by muted wage inflation. The latter is moving sideways at a low level in the eurozone currently. Overall, we expect core inflation to drift higher, albeit grudgingly.

MONETARY POLICY

The profile for core inflation will ultimately determine the future actions of the European Central Bank (ECB). We expect the ECB to see the current asset purchase programme through to completion in September of this year, and then terminate at that point. Thereafter, although speculation is likely to build, we do not expect the ECB to deliver a rate hike at least until late-2019 as underlying inflation remains contained and residual spare capacity is eroded further.

Chart 3

Eurozone core inflation vs unemployment relative to the NAIRU



Sources: Macrobond, Scotiabank.

Brazil

- **The performance of the Brazilian real (BRL) in 2018 is likely to be dictated by external factors, and internal politics. The key political element to monitor is whether enough reforms will be approved to stabilize the country's rapidly deteriorating fiscal position.**
- **In terms of specific events, pension bill approval is likely the key event, but not the only one. Lula's appeal process will be relevant to the likelihood of a pro-establishment president keeping power in 2019. Public asset privatizations are another factor facing hurdles—and a relevant one to meeting fiscal targets. In addition, a newly emerging risk is whether restrictions on public borrowing to finance current spending will be relaxed. If the restrictions to public borrowing for non-investment spending are unwound, it is likely to be seen as a sign that the 2018 fiscal targets will be missed. This would pressure BRL.**
- **Consistent with this fiscally focused outlook for the BRL, S&P is reported to have said on January 4th that it might take negative action on the country's credit ratings before the expected pension bill vote in mid-February. All this translates into relatively front-loaded negative risks for Brazil in 2018.**
- **There is still a window to avoid this negative spiral from becoming reality, by securing enough reform progress before electoral campaigns highjack legislator agendas, but this window is rapidly closing, and we expect it to shut by April–May.**

This looks to be a volatile year for BRL, with politics likely to remain the top driver for the real through the year. At the heart of the political risk, is the government's capacity to reverse the country's rapid fiscal deterioration—as well as its negative credit ratings trajectory. Achieving this is highly dependent on the President's ability to gain legislative support for reforms. One of the "bad news" items we've recently received, came on January 4th, when S&Ps said it might take credit rating actions on the country even before the anticipated vote on the pension bill in mid-February. This seemed to fly in the face of local consensus that rating agencies would wait for the outcome of the October elections before making credit ratings changes. Among the heavy pipeline of major events to follow, it is important to focus on:

- The court ruling on former President Lula's appeals, which should affect who the players will be in the October Presidential Election. At the moment, Lula continues to lead all other contenders in the polls, but it will be important to watch whether courts allow him to contend for the presidency. The first ruling is expected to come in the final week of this month and, based on comments from local political analysts, it seems like the whole process could be finished by May 2018. At the moment, the contenders that make markets most uneasy seem to be Lula, or whoever represents the PT, and anti-establishment candidate Jair Bolsonaro.

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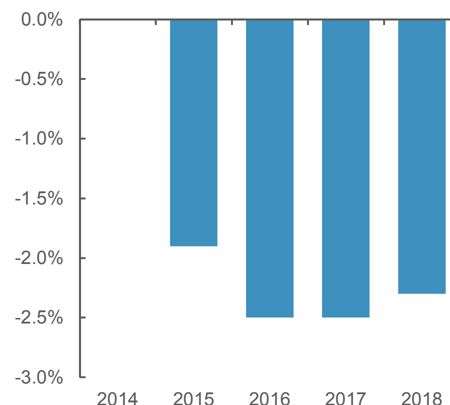
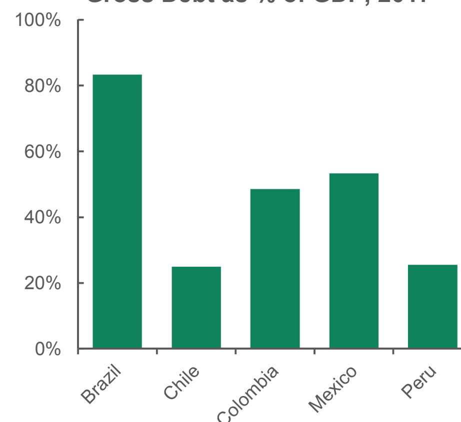
Chart 1



Sources: Scotiabank Economics, IMF.

Chart 2



Sources: Scotiabank Economics, IMF.

- There is also rising uncertainty over whether the so-called "Golden Rule" will be amended, relaxing restrictions on the ability of different levels of government to borrow not only to finance investment (as the rule currently states), but also to fund current spending. Based on comments by key legislators, it seems like a relaxation of these restrictions is a rising probability—which should be seen as a symptom of the unlikelihood that the annual fiscal goals will be achieved.

- Pension reform approval: The past year has been a roller-coaster for pension reform approval expectations. What was initially seen as a likely positive event, now seems increasingly unlikely to materialize before the Presidential elections. There remains some hope that the reform could clear the lower house mid-February and later proceed to the upper house, but the vote math looks tough. The last tally we saw from local media set the pro-reform votes about 50 short of the necessary 308 votes, and the more the negotiation process drags on, the more complex it will become to pass the unpopular bill. Hence, we think the window is rapidly closing—and there is increasing talk that without pension reform, ratings cuts again become a major risk for Brazil.

- Privatizations: One of the previously expected positives for both public finances and BRL (a large part of the acquisitions were expected to be by foreigners), was the government's fairly ambitious privatization plans (here is the Federal Government's list). Our take is that a large share of market players were fairly constructive on the results. However, recent media reports suggest that Legislative support for the privatization agenda is wavering, including that for a stake sale in Eletrobras. According to Government Affairs Minister Marin, legislators will not even discuss the potential privatization until after the pension bill is voted on, which suggests the window for this asset sale may also be shutting for 2018.

Overall, we see the BRL risks for the year as fairly front-loaded, but the second half of the year includes the October Presidential elections, which are also highly relevant—particularly if, as current polls suggest, the front runners are Lula and Bolsonaro—over whom markets seem somewhat uneasy.

Colombia

- **With growth improving, and inflation abating, market focus is likely to be on the fiscal story, and the upcoming Presidential elections. We think the former will be the more relevant market driver of the two.**

- **Strengthening oil markets should help the Colombian peso (COP), and may also to some extent bail out the government on the fiscal pressures it is facing, but we don't think the government is exactly erring on the side of caution on the fiscal side.**

- **We don't see local markets as particularly cheap, which presents the risk that investors may decide to pull out to position investments elsewhere. Foreign holdings of TES (local government nominal securities) have increased from around 20% to near 30%, and there is some risk we could see repositioning if the risks facing countries in the region, such as Brazil or Mexico, moderate somewhat.**

With growth expected to post a moderate upswing this year, and inflation dropping over the past couple of months (and expected to continue to do so), market focus in 2018 is likely to be on the fiscal story, and the elections. On the fiscal side, we think it still looks unjustified to view the country's investment grade ratings as "at risk", and hence any downgrades by Moody's or Fitch, should be only "catch-ups" to S&P's December cut. However, there are a couple of things we are concerned about related to the fiscal story:

- One of the anchors for Colombia's fiscal position is the fiscal rule (an overview of Colombia's fiscal rule can be found here). One of its weaknesses is the lack of clear formal enforcement procedures for both spending and the budget balance (in LATAM, Brazil, Peru and Mexico's rules do have formal enforcement mechanisms, while Chile and Colombia don't). In addition, there have recently been questions (in our view justified) on whether the assumptions being made about macro variables to project fiscal performance going forward are realistic. The main points centre on whether Colombia can grow as fast as its fiscal rule assumptions suggest (the pace of growth is projected at over 4% for the forecast horizon). We are skeptical that Colombia's growth potential is as high, we think it's closer to 3%, rather than in the 4.0% to 4.5% range as the government projects. Hence, results may be worse than projected debt trajectories suggest.

- The second issue is related to the government's response to the latest credit rating downgrade (by S&P to "BBB-"). Although the rating's outlook was shifted to "stable" (good news, and justified as we don't think Colombia currently deserves junk status), it was also worth bearing in mind they now sit on the verge of the "junk ratings cliff". Hence, the government's response which suggested they are comfortable with the status quo (i.e., stable ratings), rather than announcing a plan to set public finances on an improving trend is concerning, as the country now has little room to handle potential shocks (an unexpected one could tip the country into junk territory and could

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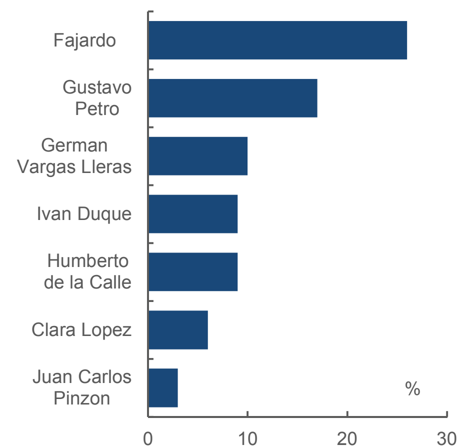
Chart 1



Sources: Centro Nacional de Consultoría (CNC).

trigger some outflows from the local markets, as some investors could face mandate restrictions due to credit ratings). If a drop to junk becomes a risk, COP would likely suffer a strong shock.

On the election front, we think news will be better. Recent polls have put Sergio Fajardo, Gustavo Petro, and German Vargas Llera as the leaders in voter intentions. Of the three, Petro is the one markets seem most uneasy about. However, we expect that as the pro-establishment candidate list narrows (likely to Fajardo, and someone representing the Santos and Uribe camps), we will likely see the race narrow to one between 3 market favourable players. Hence, we think election risk is not as strong as fiscal risk—but it's worth noting that, around the globe, polls have missed the mark substantially in the past couple of years.

We have not altered our calls for COP's direction, but highlight that there is quite a binary path for the Colombian peso:

- If, as we expect, a "market friendly" candidate is the victor in this summer's election, and the positive appetite for investing in emerging markets (EM) remains in place, alongside strong oil prices (our house call has oil prices in the US$52/bl–US$56/bl range), COP should remain supported, and we could see a move towards the 2,700 / USD area.

- However, if oil prices dip further than we anticipate, an unexpected shock puts ratings at risk of "junk status", or appetite for EM does not remain as strong as we expect it to, then we could see USDCOP move higher than the 3,000–3,100 range we anticipate—potentially to the 3,500 area.

Peru

THE DIVERGENT IMPACT OF POLITICS AND TERMS OF TRADE

- **In 2018 politics remains a concern, but should be compensated by higher metals prices and healthy economic fundamentals.**
- **We have adjusted our Central Bank call from one rate cut to two during 2018, in reaction to low inflation.**

Politics trumped Economics in Peru in 2017. However, now that the political dust has settled a bit, the future does not look quite as bad as it seemed last month when Congress was seeking to impeach President Kuczynski (PPK), and the presidential pardon awarded Alberto Fujimori sparked a wave of protests.

The impeachment motion was defeated and protests have subsided... so far. Although political noise will not go away in 2018, it may become manageable enough to have less of an impact on the economy. Uncertainties abound on this count. Future political conduct and performance will depend on how the parties restructure internally, and realign with each other and with the government. Lava Jato investigations will continue, potentially affecting both PPK and the opposition.

Although the political divide is so wide that it is difficult to conceive a smooth political path going forward, with metal prices rising and healthy macro balances, the impact on the economy is likely to be much more benign than otherwise. Growth figures in the latter half of 2017 were improving before the period of greatest political turmoil, but there is likely to have been a degree of pause in both public sector and private sector investment since December.

We shall be reviewing our 2018 GDP forecasts once we have a clearer view on how quickly the government is able to put public sector investment back on track. Note, however, that whereas before we saw upside to our 3.7% GDP growth forecast, we now see mild downside. Government spending, in particular, may come in somewhat below our 15.4% estimate. Smaller or less sophisticated investment in reconstruction should continue—such as housing and river bed reinforcement—but large projects are likely to be delayed to some extent. Spending on the Pan-American games and annual budgetary investment should proceed as normal, though.

We've become more bullish on Central Bank policy, due to low inflation, which closed 2017 at 1.4%. The downtrend is strong, and we agree with the CB in expecting inflation to dip below the 1% floor of its target range in early 2018. The combination of low inflation and countering the impact of political turmoil on growth justifies more than one decrease in rates, and we are adjusting our expectations from one rate cut in the year, to two rate cuts, to 2.75%. After dipping early on, inflation should rebound rather quickly, although not significantly. We have lowered our full-year forecast to 2.0%, from 2.8%.

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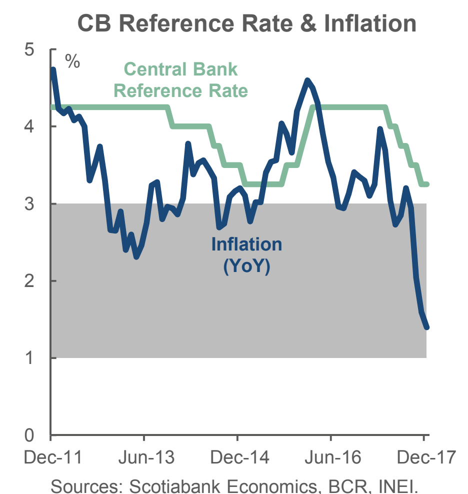
Chart 1



Sources: Scotiabank Economics, BCR, INEI.

As for the FX market, political uncertainty does not change the reality of improving terms of trade. Nor does it endanger the country's debt profile. Short-term knee-jerk reactions to political events are likely to continue, with an impact on the FX and the soberano curve, but it's hard to envision a political/economic scenario so dire as to lead to a persistent hemorrhage of financial capital from local markets over a longer term.

Growth in 2019 will depend, in part, on what happens in 2018, but better terms of trade and continued public investment should bolster GDP growth to 4.2%. We are hopeful that political turmoil will ebb, but note that it probably has already had some impact on longer-term growth.

Chile

A MODERATE RECOVERY SEEMS MORE LIKELY DAY-BY-DAY

- **Two factors will be critical for the Chilean economy in the current year: the copper price trend and the new government's ability to work with the opposition to pass reforms that would enhance investment. These two factors will also be the critical risks.**
- **Business confidence could improve much more if the new administration moves quickly on key reforms.**
- **The economy is basically balanced: low inflation trending up, a limited current account deficit, fiscal conditions worsening but still manageable, and a solid financial sector.**

MACRO UPDATE: GOOD CONDITIONS ARE SUPPORTIVE FOR OPTIMISM

Much of the market is expecting a stronger performance in the last quarter of 2017, but we are keeping our annual growth forecast of around 1.4% for 2017. Our forecast for the current year remains at 2.8%, though the upward bias has strengthened significantly due to higher expectations for copper prices, a calmer international outlook and lower domestic political risks. Accordingly, the first half of the year will be critical for the Chilean economy and market forecasts could be revised more than usual, in both size and frequency.

A key variable to track will be the recovery of private expectations which is critical to domestic demand (consumption and, importantly, investment). Monetary and fiscal policies are expansionary, with ample spare capacity to meet demand. We have seen some signs of a recovery in confidence recently, but there are good reasons to expect that further improvement is forthcoming.

Inflation reached 2.3% in 2017, the lowest level since 2012. It is pretty consistent with an economy that has been growing below its potential rate for 4 years, characterized by a drive to efficiency in some sectors reinforced by the lagged impacts of high investments in recent years. For the current year we expect inflation will rise to 2.8%. The rebound in inflation is already underway, since inflation troughed in September. However, that uptrend will be critically linked to a tug of war between an exchange rate that might become weaker—which would impact prices of tradable goods—and the recovery of expectations and activity, whose major influence will be on non-tradable goods and services.

In that context, we continue to expect that the Central Bank will keep the Monetary Policy rate at 2.5% up to mid-year, though the bias could be modified before then. For the second half of the year we expect three hikes (25bp each) to end 2018 at 3.25%. That would be the start of a normalization policy that should continue into 2019. A moderate recovery of long-term rates should start even before that, as soon as the current quarter.

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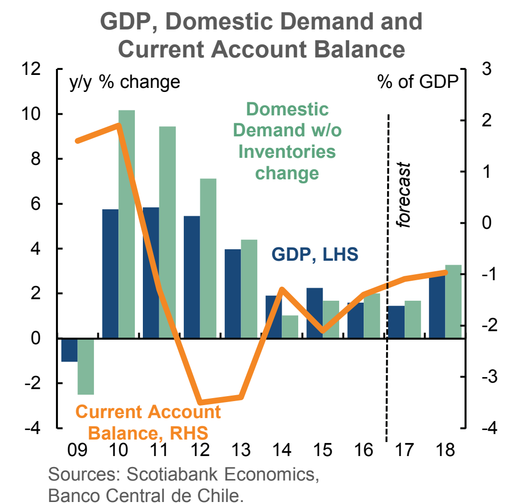
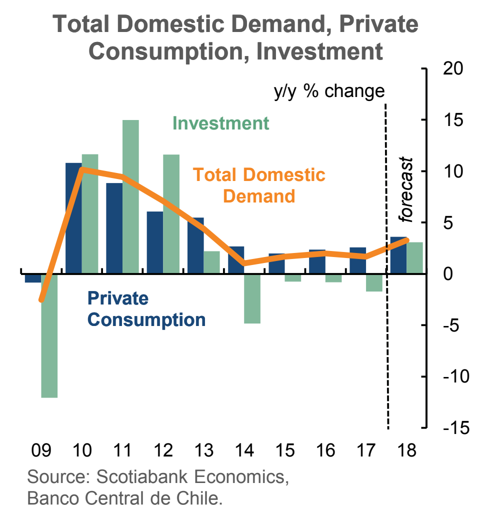
Chart 1



Sources: Scotiabank Economics, Banco Central de Chile.

Chart 2



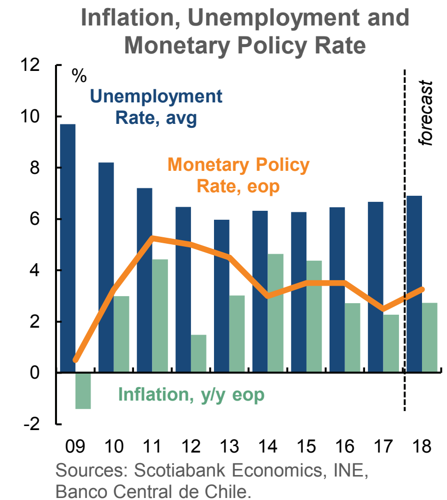
Source: Scotiabank Economics, Banco Central de Chile.

POLITICAL PANORAMA: RISKY BUT PROMISING

The political panorama seems to be much clearer than before. Parliamentary elections did not result in an absolute majority in Senate or in Chamber of Deputies. However, the decisive win for Mr. Piñera, with the deeply divided and confused opposition, make Mr. Piñera's coalition of parties the strongest force in Parliament. Even so, they will have to strive to reach agreements with other forces to get required majorities. The task is huge and will require great political skills. On the positive side, it appears that Mr. Piñera favors almost everything that markets can dream of for the region: more room for private activity, more fiscal responsibility, more growth, etc., paired with experience and strong political and technical leadership.

The new President is aware of the importance of moving quickly to improve the economic situation (probably the main reason why he was so convincingly elected). In addition to the traditional one-year "honeymoon period" between the new President and the Chilean people, the runoff election result was so categorical that any attempt to hamper the new President's actions will likely be stifled by public opinion. Accordingly, the first months will be critical to begin fixing problems in the economic framework. Financial markets and decision makers in corporations will be tracking the performance of the new political team and the environment.

Chart 3



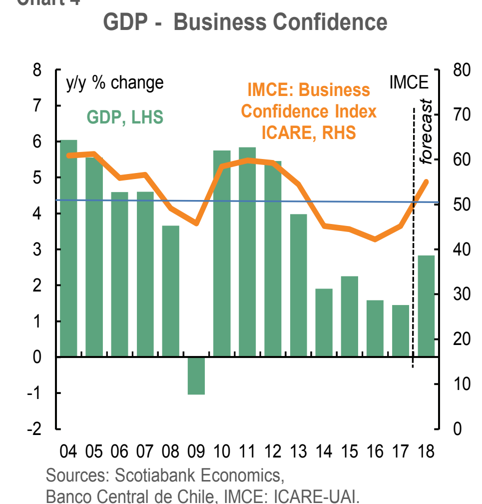
Sources: Scotiabank Economics, INE, Banco Central de Chile.

MAIN RISKS ARE THE SAME

The main risks for our forecasts are the same issues that allow us to be optimistic. We expect a limited but sustained recovery in the price of copper which, if it is too fast, could cause some troubles with exchange rate and monetary policy. However, the opposite risk (if copper prices fall) would be much more harmful: growth would be lower with implications for the foreign and fiscal accounts. The forecasted trend to a potential growth between 3.5% and 4% in coming years would be considerably harder to reach.

Domestic risks have probably been overestimated, but they remain important. Some abilities of the new government were tested in the first administration of Mr. Piñera who governed Chile from 2010 to 2014, but one should expect some improvements. On the positive side, if political management were excellent and smoother than expected, opportunities for investment would be extraordinary and some variables like unemployment could react accordingly. But the flipside is that the opposition will not be naïve: the real term of a coalition government in Chile is likely not 4 years, but 3. Within that period, municipal elections will take place, which have proved to be a good predictor of the presidential and parliamentary elections the following year.

Chart 4



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

China

- **Strong global growth creates a supportive environment for China's structural reform implementation.**
- **China's new leadership will likely prioritize financial sector reforms.**
- **Prudent and neutral monetary conditions will support economic growth.**

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THE CHINESE ECONOMY'S STRUCTURAL TRANSITION ADVANCES

The favourable global economic environment will provide a suitable framework for Chinese authorities to implement necessary reforms. Our expectation for meaningful progress in the reduction of structural imbalances—such as inefficient allocation of resources, excessive credit growth, inadequate pricing of risk in various asset classes, capital controls—will decrease the economy's downside risks over the medium term and will help China to remain one of the global growth outperformers in the foreseeable future. Nevertheless, China's structural transition from investment- and industrial-sector-driven activity to one powered by consumer spending and the services sector will continue, leading to somewhat slower—yet better quality—real GDP growth over the coming years. We expect the Chinese economy to expand by 6½% y/y this year—in line with the government's anticipated target for 2018—following an estimated 6.8% gain in 2017. In 2019, the pace of expansion will likely slow further but will remain slightly above 6% y/y.

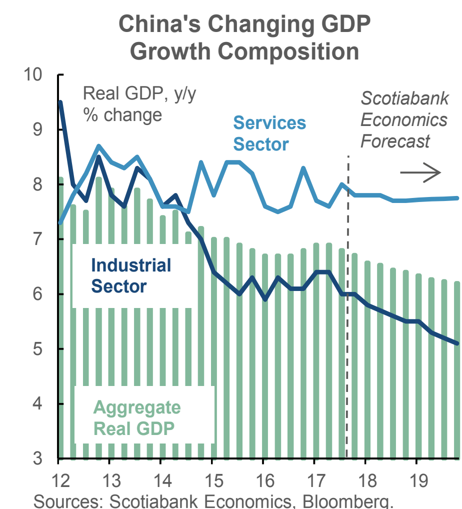
High frequency data on China's economic activity over recent months confirm that decelerating forces are at play. The slowdown in industrial activity reflects both the ongoing long-term trend of economic rebalancing as well as the short-term impact of sizable factory closures that have been put in place to meet environmental standards during winter months. Based on our calculations, fixed asset investment growth in the secondary sector (i.e., industry) has slowed to around ½% y/y over the past few months, while investment in the tertiary sector (i.e., services) continues to propel ahead by close to 8% y/y (chart 2). Now, services sector investment accounts for 60% of China's total fixed asset investment. The economic transition results in a rise of the Chinese consumer. We assess that prospects for maintained household spending gains are encouraging; indeed, real disposable income growth was solid at 7.5% y/y in the first three quarters of 2017 (chart 3), outperforming the nation's real GDP growth.

Robust global demand will underpin China's export sector activity, providing a cushion to the economy's domestic structural transition and room to maneuver for the country's authorities as they adjust policies to address underlying imbalances. Indeed, Chinese exports (in US dollar terms) rose roughly by 8% y/y in 2017, driven by strong demand from advanced economies in North America and Europe. Nevertheless, an even stronger pace of import growth in China has led to a narrowing of China's merchandise trade surplus.

REDUCTION OF FINANCIAL RISKS IN SIGHT

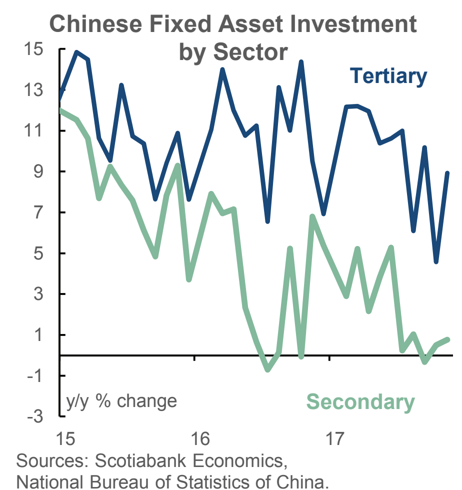
China has a new leadership for the next five years following the 19th National Congress of the Communist Party of China (CPC) at end-October. President Xi

Chart 1



Sources: Scotiabank Economics, Bloomberg.

Chart 2

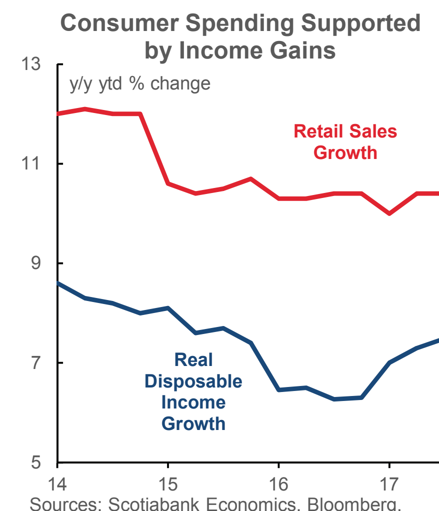


Sources: Scotiabank Economics, National Bureau of Statistics of China.

Jinping and Premier Li Keqiang were the only members retaining their position in the newly-elected Politburo Standing Committee (PSC); the five new member nominees did not reveal a potential successor for President Xi, which implies that he may remain in power beyond 2022. The new PSC members—who will be confirmed in March by the National People's Congress, China's parliament—have expertise in such areas as economic management, finance, foreign policy, political reform, legal systems, and party ideology. Given the composition of the PSC, we believe that the policymakers will place greater emphasis on the following three issues over the next five years: 1) advancing China's economic liberalization and structural reforms; 2) preserving the CPC's future and the socialist ideology; and 3) increasing China's role in global affairs.

The first one of these issues will have the greatest impact on China's economic outlook. Strengthening the banking system's resilience will likely be given priority because it is a prerequisite for further economic liberalization. Indeed, in the near term Chinese authorities will likely focus on improving the financial industry's risk management systems, bolstering its regulatory framework, promoting systemic deleveraging, increasing transparency, and managing the resolution of troubled loans. We are relatively optimistic about continued progress in tackling the economic imbalances stemming from the financial industry. One of the key examples of encouraging policy changes is the recent announcement regarding tighter rules on asset management businesses in order to reduce systemic risks related to the shadow banking industry. We assess that this is a significant and needed reform, given that the pricing of risk related to shadow banking products has been inadequate. That has made the industry one of the weakest links and biggest risk factors in the Chinese economy particularly given its sizable links to the economically-important real estate sector. The shadow banking industry has been giving investors implicit guarantees against losses, reflecting the practice that funds from new product issuance have been used to cover investment losses from older ones. The new rules—which have an implementation period until mid-2019—will prohibit such practice and will set harmonized rules across the financial industry to prevent regulatory arbitrage. Nevertheless, we believe that long-term gain will not come without short-term pain; bouts of market turbulence can be expected over the coming quarters as the magnitude of nonperforming debt in the financial system becomes clearer.

Chart 3

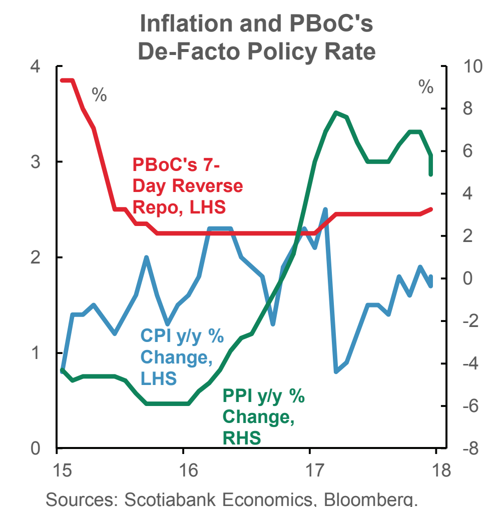


Sources: Scotiabank Economics, Bloomberg.

GROWTH-SUPPORTIVE MONETARY POLICY TO BE MAINTAINED

China's outlook for consumer price inflation remains manageable despite elevated producer price pressures. In our view, weaker demand for raw materials resulting from the government's efforts to curb pollution will likely lead to lower producer price inflation in the near future. The consumer price inflation rate closed 2017 at 1.8% y/y (chart 4). We expect price gains to remain around the 2% mark over the next few months before reaching 2.5% y/y by the end of 2018.

Chart 4



Sources: Scotiabank Economics, Bloomberg.

The People's Bank of China (PBoC) remains committed to continued implementation of "neutral and prudent" monetary policy, as it helps maintain a favourable financial environment for structural reforms and stable real GDP growth. While the official benchmark one-year loan and deposit rates are expected to be left unchanged in 2018 (at 4.35% and 1.50%, respectively), the 7-day reverse repo rate—the PBoC's de-facto policy rate—will likely continue to be raised cautiously. The 7-day reverse repo rate was increased by 25 basis points (bps) in 2017, with the most recent hike (of 5 bps) taking place in December. Despite gradual tightening, monetary conditions are set to remain relatively loose and growth-supportive overall through 2018.

Japan

- **Well-balanced economic growth amid supportive political environment.**
- **Differentiation between monetary policies of the Bank of Japan and other major central banks.**

ECONOMIC GROWTH LIKELY TO STAY ABOVE POTENTIAL IN 2018

Japan's economic growth is well balanced, encompassing domestic demand and the external sector. Higher corporate profits are bolstering fixed investment, while improving labour market conditions are supporting household spending. A pick-up in global demand has translated to stronger activity in Japan's manufacturing and industrial sectors (chart 1). Indeed, the country's export volumes growth averaged over 5% y/y in 2017, led by firm demand from Asia for Japan's IT-related goods. We expect Japan's real GDP expansion to average 1.4% y/y in 2018 following an estimated 1.8% gain in 2017. While productivity improvements and increased labour force participation have nudged Japan's potential growth rate slightly higher to ½–1% y/y, the economy will continue to outperform its trend pace and maintain the positive output gap that emerged in 2017. In 2019, output growth is set to decelerate to a more sustainable level of around 1% y/y reflecting cyclical factors and the scheduled consumption tax rate increase in October 2019.

Japan's political setup is supportive of maintaining economic revival policies. Prime Minister Shinzo Abe's Liberal Democratic Party (LDP) and its coalition partner, the Komeito party, retained their two-thirds super-majority in the lower house following the general election in October 2017. The strong position will allow the coalition to pass legislation without approval from the upper house. Mr. Abe is well-positioned to continue as the head of the LDP following the party leadership poll in September 2018, which means that he will likely remain Prime Minister through 2021.

ULTRA-ACCOMMODATIVE MONETARY POLICY MAINTAINED IN 2018

Stimulative monetary conditions will remain in place in 2018–19 given the Bank of Japan's (BoJ) pledge to reach the 2% y/y inflation target. While other major central banks have started to shift away from loose monetary policies, our status quo forecast for Japan reflects a weak inflation outlook and the looming sales tax rate hike that may halt the economy's recovery. The BoJ will likely maintain the short-term policy rate at -0.1% and adjust the amount of bond purchases depending on market developments, aiming to keep 10-year bond yields close to 0%. Reduced bond purchase amounts do not signal tapering as long as the BoJ leaves the 10-year yield target unchanged. The BoJ has highlighted that the cumulative stock of bond purchases impacts interest rates more than each operation on a flow basis.

Japan's inflation remains muted, averaging around 0.5% y/y in 2017. We expect only a modest pick-up through 2018, taking the headline rate to 1.1% y/y by year-end. Despite Japan's relatively strong output growth and a tight labour market, wage inflation remains near zero (chart 2), keeping demand-driven inflation at bay in the foreseeable future. We do not expect the BoJ's 2% y/y inflation target to be met in 2018 unless wage gains—or global energy prices—pick up in a more notable fashion. The planned increase in the consumption tax rate (from 8% to 10%) will temporarily take headline inflation above the 2% mark in late 2019.

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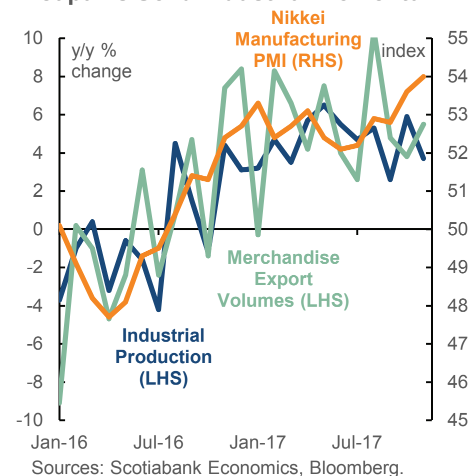
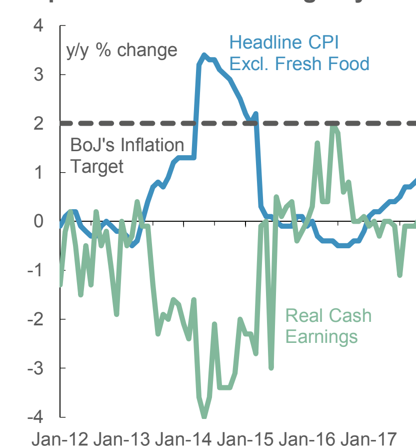
Chart 1



Sources: Scotiabank Economics, Bloomberg.

Chart 2



Sources: Scotiabank Economics, Bloomberg.

India

- **Nascent signs of economic growth recovery are emerging.**
- **Intensifying inflation will prevent further monetary easing.**
- **Authorities' efforts to clean up banks' balance sheets are encouraging.**
- **Fiscal slippage concerns persist.**

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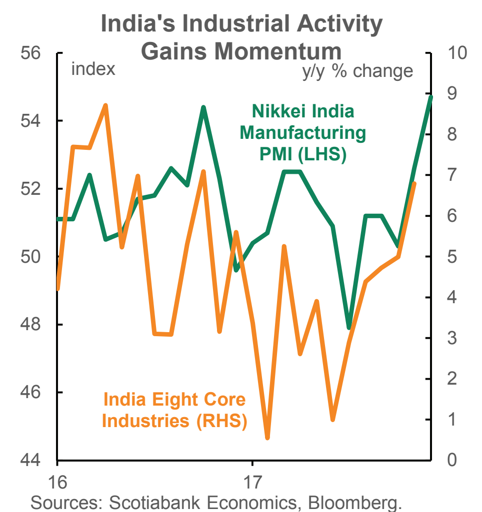
INDIAN ECONOMY ON THE MEND

India's economic growth is recuperating from the soft patch that was caused by disruptive reform implementations, such as the demonetization initiative a year ago and the Goods and Services Tax in July 2017. Indeed, business confidence in both the manufacturing and services sector is showing signs of recovery along with strengthening industrial and export sector activity (chart 1). Nevertheless, consumer confidence has yet to firm up.

In our view, the Indian economy will be well-positioned to benefit from the medium- to longer-term impacts of recently implemented structural reforms after the short-term adverse effects dissipate further. Indeed, the government's decisive efforts to tackle the economy's multiple structural issues via the tax reform, a new bankruptcy code, bank recapitalization, and various efforts to formalize the economy are expected to improve the business environment and translate to a sustained pick-up in fixed investment. Meanwhile, we expect the stronger business conditions to translate to better income and employment prospects, boosting household sentiment and spending over the coming quarters. In addition, Indian exporters will benefit from stronger global trade activity even though the economy is more driven by domestic demand when compared to its regional export-oriented peers. Given the reasonably favourable outlook, we forecast that India's economic growth will continue to strengthen, averaging 7½% y/y in 2018–19 after an estimated 6.3% advance in 2017 (chart 2).

Chart 1



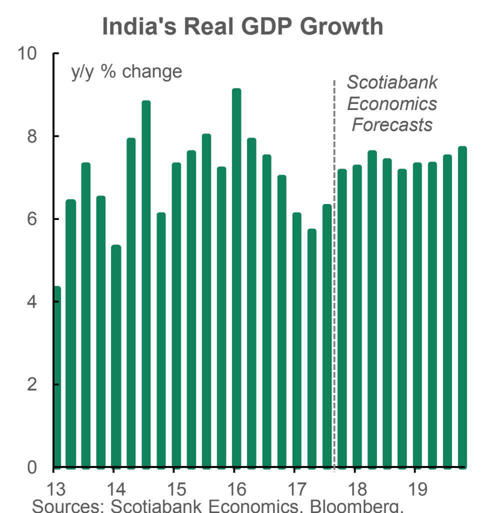
Sources: Scotiabank Economics, Bloomberg.

RE-EMERGING INFLATIONARY PRESSURES

Inflationary pressures are building in India; headline inflation has climbed to around 5% y/y from the June low point of 1.5%. We expect further modest acceleration over the coming months (chart 3), yet inflation will likely stay within the Reserve Bank of India's (RBI) medium-term target of 4% ±2% y/y. While higher food and fuel prices have been the key contributors to the recent increase, underlying inflation has accelerated as well; our core inflation estimate rose from 3.9% y/y in mid-2017 to 4.9% in November. Demand-driven price pressures are intensifying partially due to a higher Housing Rent Allowance given to government employees. Accordingly, the RBI will continue to pay particular attention to the risk of fiscal slippage by the government as it evaluates the appropriateness of the current monetary policy stance.

We expect the RBI to keep monetary policy unchanged in 2018. The benchmark repo rate was cut by 25 bps to 6.0% in August 2017. Reflecting the nascent economic recovery and accelerating inflation, we assess that the next monetary policy move will be a hike, likely to take place in the first quarter of 2019 (chart 3).

Chart 2

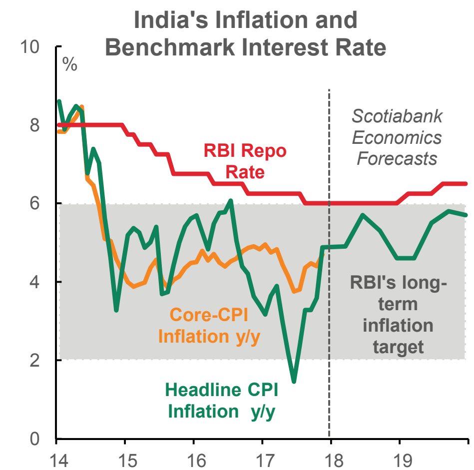


Sources: Scotiabank Economics, Bloomberg.

FINANCIAL SECTOR REFORMS SUPPORT THE OUTLOOK

One of the key steps to revitalize the Indian economy was taken at the end of October 2017; the Indian government approved a sizeable two-year recapitalization plan for the country's public sector banks that have been suffering from elevated non-performing assets. Banks' weak balance sheets have been one of the key reasons why monetary policy transmission has not worked adequately and the RBI's benchmark interest rate cuts have not passed through to lending rates completely, failing to promote stronger economic growth. More than half of the recapitalization amount (of around USD 32.4 bn) will come from the sale of special recapitalization bonds while the rest will come from banks' share sales and the government's budgetary provisions. The RBI has welcomed the initiative, pointing out that the plan front-loads capital injections while it spaces out the associated fiscal implications over a period of time. In a similar fashion, we consider the plan favourable and assess that it will encourage a pick-up in lending in the Indian economy. The bank recapitalization program supports the Insolvency and Bankruptcy Code—which has been in effect since December 2016—easing corporate stress and improving the country's business environment further.

Chart 3



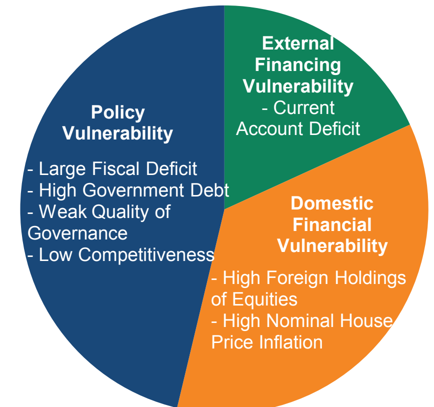
Sources: Scotiabank Economics, Bloomberg.

RISK OF FISCAL SLIPPAGE UNDERMINES THE OUTLOOK

India's fundamental weaknesses and risks lie on the fiscal front (chart 4). Still-muted—though improving—economic growth may prompt the Indian government to consider new fiscal stimulus measures to underpin domestic demand, particularly household spending. Meanwhile, the RBI has repeatedly pointed out that fiscal slippage is one of the key risks to the country's inflation outlook. Accordingly, rising government bond yields demonstrate that speculation regarding a looser fiscal stance has triggered investor concerns about the country's inflationary developments and the sustainability of India's fiscal position.

The cumulative deficit for FY2017–18 (April–March) reached 112% of the budgeted target by November 2017. Consequently, it seems unlikely that the Indian administration will be able to meet the central government deficit goal of 3.2% of GDP this fiscal year (at the general government level, India's fiscal shortfall is much larger, around 6½% of GDP). The Union Budget for FY2018–19 is expected to be unveiled on February 1; on the back of lacklustre revenue growth dynamics and higher borrowing requirements, the government may have to revise its target of narrowing the fiscal shortfall to 3% of GDP by FY2018–19. In addition, the potential for the budget to be populist in nature—given that it will be the last full budget before the 2019 general elections—will be one of the key issues to watch out for in the near future.

Chart 4



Sources: Scotiabank Economics, IIF.

South Korea

- **South Korea will maintain solid economic growth amid persistent North Korea risks and trade-related uncertainties.**
- **The Bank of Korea leads the way in monetary tightening in Asia.**

THE SOUTH KOREAN ECONOMY DEFIES KEY RISKS

The South Korean economy will likely continue to record solid growth despite elevated geopolitical and trade-related uncertainties. Activity remains underpinned by growth in fixed investment and exports that reflect firm global demand. South Korean consumer confidence is sound, pointing to continued household spending momentum; prospects will be further boosted by the January increase (of 16%) in minimum wages. Meanwhile, the government's 2018 budget maintains a supportive fiscal policy stance while monetary conditions remain accommodative despite gradual normalization. We expect South Korea's real GDP to grow by 3.0% y/y through 2019 following an estimated 3.2% gain in 2017.

North Korean nuclear ambitions form the main risk to South Korea's economic outlook in 2018. Escalation of geopolitical tensions on the Korean Peninsula could dent consumer and business confidence, adversely affecting household spending and business investment. Moreover, an increase in the North Korea risk could also trigger financial market turbulence, yet South Korean authorities are expected to intervene effectively to maintain financial stability.

Protectionist biases in the US create another source of risk to the export-oriented South Korean economy. South Korea has agreed to renegotiate the bilateral South Korea-US free trade agreement (KORUS FTA) on the back of pressure by the US to terminate the trade pact. The timing of potential trade frictions resulting from renegotiations is challenging given that the stalemate with North Korea requires a well-functioning relationship between the US and South Korea.

MONETARY POLICY TO BE TIGHTENED CAUTIOUSLY IN 2018

A monetary normalization phase has commenced in South Korea following the Bank of Korea's (BoK) decision at end-November to raise the 7-Day Repo Rate by 25 basis points to 1.50%, which marked the first hike in over six years. The central bank will likely adopt a cautious approach to monetary tightening over the coming quarters on the back of only modest upward pressure on prices and external risks related to: monetary policy actions in major economies, trade, and geopolitics. We forecast two more hikes over the course of 2018—likely to take place in the second and fourth quarters—taking the benchmark interest rate to 2.0% by year-end (chart 2), followed by one more rate increase in 2019.

Solid economic momentum in South Korea will likely trigger a gradual pick-up in demand-driven inflationary pressures over the coming quarters. While we estimate that headline inflation will remain slightly under the BoK's 2% y/y inflation target in the first half of 2018, price pressures will likely intensify gradually later in 2018. Nevertheless, the BoK's tighter monetary policy stance will help keep inflation controlled, below 2½% y/y through 2019.

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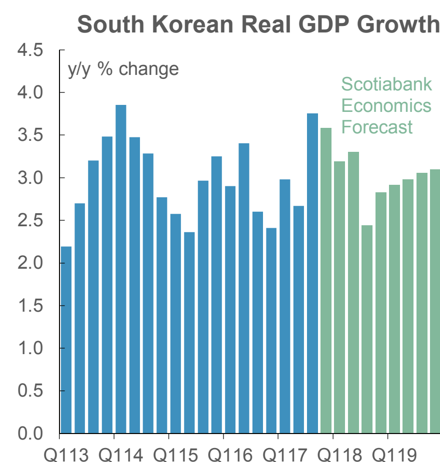
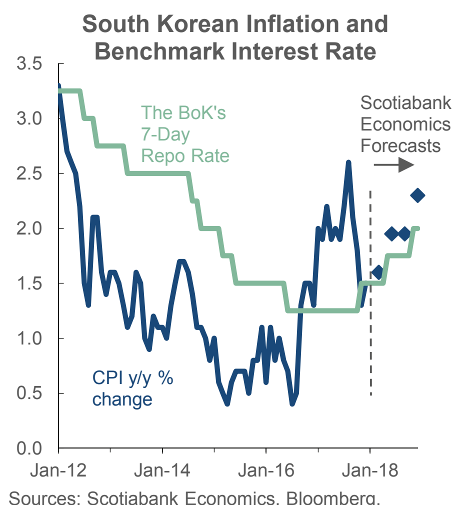
Chart 1



Sources: Scotiabank Economics, Bloomberg.

Chart 2



Sources: Scotiabank Economics, Bloomberg.

Australia

- **Strong labour market will support wages and domestic demand.**
- **The RBA will likely join the monetary tightening club in late-2018.**

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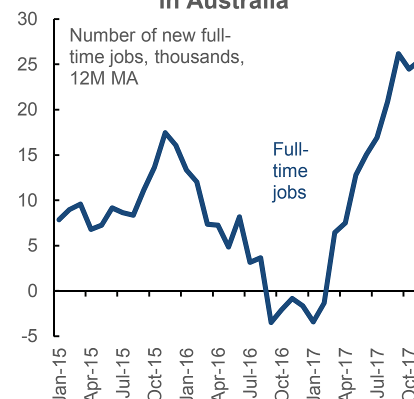
LABOUR MARKET PLAYS A KEY ROLE IN AUSTRALIA'S OUTLOOK

Australia's economic outlook for 2018 is solid. We expect the country's real GDP to expand by 2.7% in 2018—in line with its potential growth rate—following an estimated 2.4% gain last year. Despite higher export volumes, net exports are not contributing to Australia's real GDP growth due to weaker terms of trade—partially related to a lower price of iron ore, which accounts for a quarter of Australia's exports—together with slower growth in commodities demand in China, which is Australia's main export destination. Therefore, solid domestic demand conditions are vital for continued growth momentum. Encouragingly, improved business confidence and accommodative monetary conditions have translated to a pick-up in non-mining investment. A more favourable business environment has also supported hiring, which is a very welcome development given that Australian consumers' spending power is held back by high household debt. Public sector infrastructure investment will provide further support to economic activity.

Australia's domestic outlook will be significantly impacted by the labour market. Should the recent favourable trend in job creation continue, the economy would shift to a sounder footing. Indeed, a stronger labour market would boost consumer spending, a fundamental driver of Australia's economic activity. The country's employment conditions have strengthened markedly in recent quarters with full-time employment rising sharply (chart 1). Even though labour force participation has risen, Australia's unemployment rate has dropped to 5.4%, the lowest level since 2013. Despite this, real wage gains have remained near zero, yet we expect 2018 to change this dynamic. Indeed, Australian business conditions are expected to continue improving over the coming quarters leading to further labour market tightening. Accordingly, we expect to see a more sustainable pick-up in wage inflation.

Chart 1



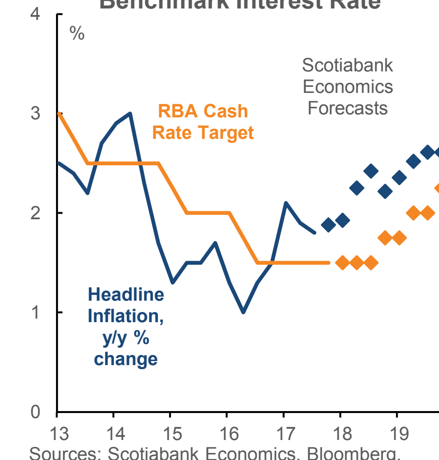
Sources: Scotiabank Economics, Australian Bureau of Statistics.

MONETARY TIGHTENING TO COMMENCE IN LATE-2018

Australia's monetary conditions will remain accommodative in order to underpin domestic demand. Nevertheless, we expect the Reserve Bank of Australia (RBA) to join most other major central banks in their policy normalization efforts in late 2018 as anticipated higher wage gains will trigger modest demand-driven inflationary pressures. Indeed, we expect a slight pick-up in headline inflation over the coming quarters (chart 2), yet the inflation rate will likely hover below the mid-point of the RBA's 2–3% target range through 2018. Price gains will likely intensify over the course of 2019, reaching 2⅔% y/y by the end of the year.

As a response to gradually accelerating price and wage inflation, we expect the RBA's first benchmark interest rate hike to take place in the fourth quarter of 2018. The central bank will likely tighten monetary policy cautiously, with additional rate hikes expected in the second and fourth quarters of 2019, which will take the policy cash rate to 2.25% by year-end.

Chart 2



Sources: Scotiabank Economics, Bloomberg.

Commodities

ENERGY & BASE METALS SHINE ON STRONG GLOBAL DEMAND, SLOWING SUPPLY

Commodity markets rang in the New Year on their front foot and virtually all industrial materials are maintaining upward momentum after cementing strong gains made over the latter half of 2017. On the supply side of the ledger, production growth is slowing as the pipeline of projects sanctioned amidst the high prices of the mid-2010s empties over the forecast horizon. But as with most coordinated rallies in the prices of raw commodities, this latest move higher was driven by demand considerations as markets anticipate booming demand for energy and metals on the back of the first synchronized global economic acceleration since the Global Financial Crisis.

The synchronized global growth narrative has supported the continued run-up in equity markets and other risk assets like commodities. And while we maintain a broadly constructive outlook on the commodities complex going forward, there are signs that recent price gains have been larger and have arrived sooner than fundamentals alone justify. This is particularly true for "Dr. Copper"—so named for the historical relationship between the metal's price and the global business cycle—where speculative commodity bets on macro growth are likely to be concentrated, with spill-over effects for the rest of the industrial metals complex. The narrative has also spilled over to the energy sector where strong demand expectations are making oil balances feel even tighter, complementing OPEC+'s supply restraint and helping lift net speculative positioning to fresh all-time highs of more than a billion paper barrels between WTI and Brent.

We anticipate tighter supply conditions for most industrial commodities in 2018 and prices will be helped higher by a depreciating dollar as well as a litany of geopolitical risks. However, we believe that the commodities complex will see some of its recent gains moderate on seasonal first-quarter demand weakness and a needed rationalization of speculative positioning before resuming a fundamentally-justified upward trajectory thereafter (chart 1).

ENERGY: OIL MARKET FEELING THE SUPPLY PINCH

Oil markets ended 2017 with all the tell-tale signs of tight fundamentals and prices currently sit at three-year highs (WTI >$63/bbl). An accelerating global economy has kept upward pressure on already-robust demand growth, OPEC+ has managed to improve upon historic levels of production cut compliance, non-OPEC oil wells outside North America are experiencing anemic growth if they're not declining outright, and the US shale patch remains the only material source of global supply gains. While we anticipate a mild seasonal surplus in the first quarter of 2018 that could derail crude's current rally, market balances are expected to remain in deficit through most of the forecast horizon (chart 2). **Tighter market conditions have prompted us to upgrade our oil price outlook, with WTI now forecast to average $57/bbl in 2018 and $60/bbl in 2019** (up from $52/bbl and $56/bbl last quarter). On top of all the standard variables, 2018 also looks primed for geopolitical intrigue: from the largest Iranian protests since 2009 to the Venezuelan state's rapid decline into chaos, it is likely

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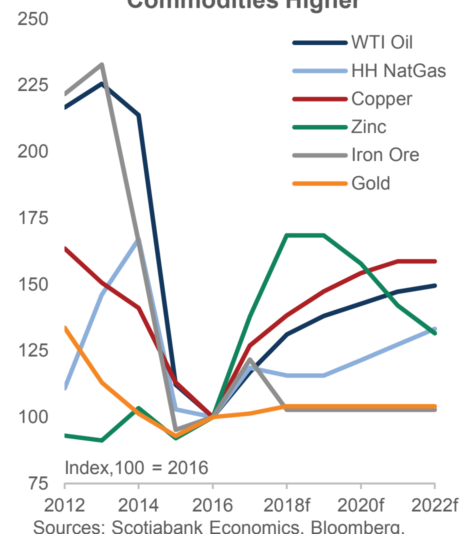
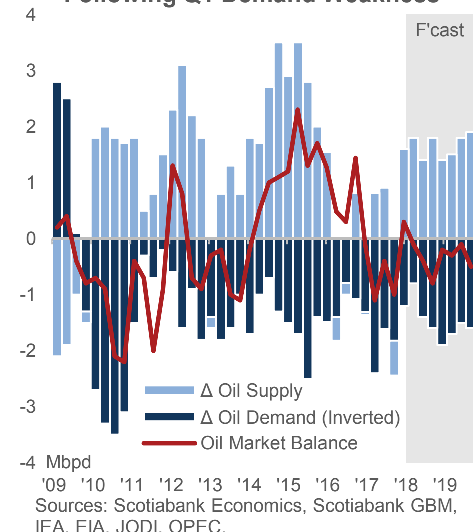


Sources: Scotiabank Economics, Bloomberg.

Chart 2



Sources: Scotiabank Economics, Scotiabank GBM, IEA, EIA, JODI, OPEC.

that crude prices will continue to benefit from a few dollars' worth of risk premia over the coming year.

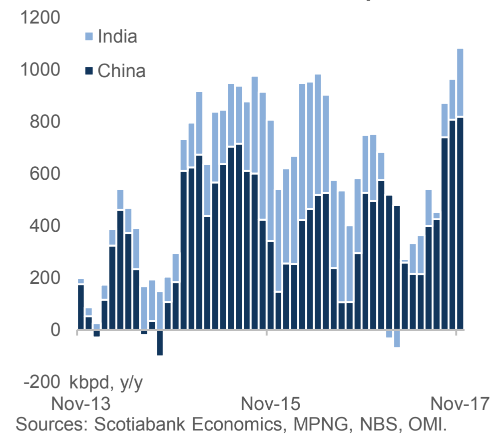
Much of the market drama is evolving on the supply side of the ledger, but the steadiest driver of the recent crude price revival has been consistently robust demand growth. Liquids consumption rose by an estimated 1.6 MMbpd in 2017 and we expect this pace to persist into 2018–19 on the back of an accelerating global macro environment. Risks to our demand outlook also appear tilted to the upside given that recent growth has been achieved almost entirely without the assistance of India, the largest growth contributor in 2016 (chart 3); a rebound in Indian consumption growth would likely be worth another 0.1–0.2 MMbpd in demand gains per year, which could help offset some of the upside risk to our US supply growth profile.

Against the backdrop of strong and steady demand growth, supply gains have been muted and volatile, up barely 0.5 MMbpd y/y in 2017 relative to consumption rising by 1.6 MMbpd. While global liquids production gains accelerated to 0.7–0.8 MMbpd by the end of the year, this growth was almost entirely a function of a rebounding US shale patch and steady Canadian oil sands expansion, which offset broadly declining non-OPEC+ output outside of North America (chart 4). We anticipate more of the same in 2018, with OPEC+ maintaining its policy of supply restraint, Canadian projects ramping up slowly, and almost the entire burden of global supply growth falling on the volatile and still uncertain US shale patch.

We expect US liquids supply to rise by roughly 1 MMbpd in 2018, but forecasts range widely between 0.8–1.2 MMbpd given continued uncertainty about the sustainability of the shale production model at prevailing price levels. On the upside, current WTI prices above $60/bbl, if maintained, would be a decisive boost for US producers after most firms spent 2017 communicating fit-for-fifty corporate strategies. On the downside, however, WTI's discount to Brent remains wide (chart 5) due to pipeline bottlenecks between Cushing and the US Gulf Coast (USGC)—depriving US producers of even higher global prices—and we are seeing early signs that productivity gains are waning as producers venture out from the sweetest spots on which many firms concentrated during the depths of the downturn. While we expect the current Cushing-USGC pipeline issue to be resolved in 1H2018, sustained growth of 1+ MMbpd will inevitably overwhelm infrastructure assets once again and WTI-Brent discounts are expected to remain structurally higher at $4–5/bbl going forward.

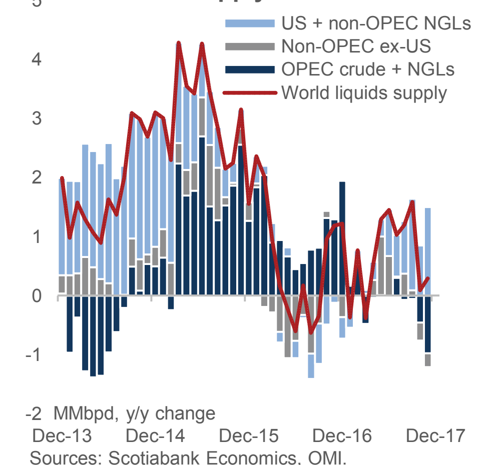
Infrastructure bottlenecks are also a long-running theme in the Canadian oil sector and are responsible for the recent blowout in the spread between WTI and WCS (Canada's primary heavy oil export benchmark) to $27/bbl from the roughly $11–12/bbl it averaged prior November (also chart 5). While a rising WCS discount was an anticipated development over the next two years, the November spill and subsequent two-week outage of the Keystone pipeline accelerated this dynamic. The WCS-WTI differential was forecast to widen in 2018–19 as production growth—buttressed by the ramp-up of the Fort Hills and Horizon oil sands projects—outstripped pipeline capacity and pushed barrels onto higher-priced rail to get to end markets. Even if rail wasn't able to absorb all of the additional supply, in-province storage stood in the wings as a final pressure valve that could hold those barrels until new pipelines entered service. Now, however, much of that inventory cushion has been prematurely filled by barrels that would have otherwise headed south on the Keystone pipeline during the two-week outage. We believe that discounts will fall from currently inflated levels of $25/bbl to nearer $18/bbl as crude-by-rail offtake agreements are signed given favourable

Chart 3



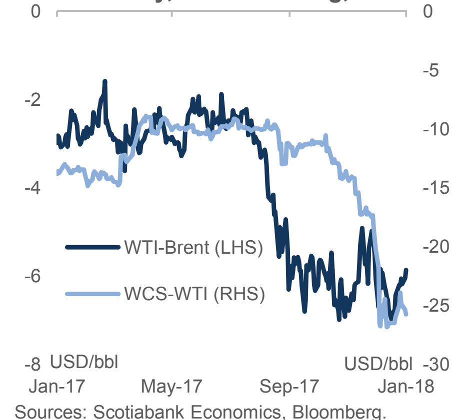
Sources: Scotiabank Economics, MPNG, NBS, OMI.

Chart 4



Sources: Scotiabank Economics, OMI.

Chart 5



Sources: Scotiabank Economics, Bloomberg.

economics, but will likely persist at this higher level until Line 3 enters service in 2H2019.

OPEC+ entered the year on a high note as November production data confirmed the best compliance levels yet for the production deal that took effect in January (chart 6). The compliance burden was also far more broadly shared between the major groups within the agreement, which reduces the likelihood that the deal will fall apart on accusations of freeriding. Make no mistake, our base case forecast and the continued health of the global oil market remains largely dependent on a continuation of OPEC+'s production discipline over the next 12 months, but historic compliance levels and affirming statements from the producer group have been a source of comfort for the market. OPEC+ will continue to monitor OECD commercial inventories (relative to their 5-year average level) as the key metric with which to gauge the state of the market's rebalancing and we expect a gradual return of withheld barrels by early 2019. We are likely to see initial exit communication come out of the scheduled June meeting, and the timing will likely be most dependent on the performance of US shale producers over the coming months. There is also the issue of Libya and Nigeria, which were exempt from the OPEC+ deal due to ongoing production challenges related to domestic militancy. These countries were a bearish footnote to last year's outlook given that production gains would erode some of the effect of the larger OPEC+ commitments. Today, Libya and Nigeria are another source of price optimism going into 2018: after lifting collective output by nearly 1.5 MMbpd since the summer of 2016, both producers are approaching output capacity and have assured their OPEC allies that they will not exceed last year's peak production level. Indeed, given recent production volatility and limited upside potential, Libya and Nigeria have a better chance of further tightening oil markets given the potential for renewed infrastructure attacks and output losses.

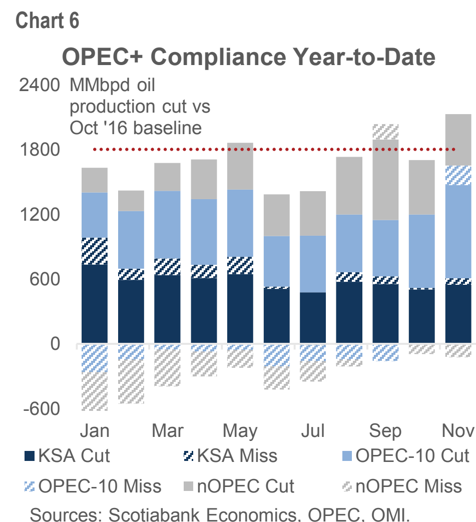
Global inventories are confirming the ongoing tightness present in supply and demand estimates. OECD commercial petroleum inventories are gradually drawing back toward their 5-year average level and US tank farms in 2017 recorded the largest annual withdraw in total petroleum stocks since the turn of the millennium. The futures market is also telegraphing spot market tightness to complement the visible inventory withdrawals. Calendar spreads have been in deep contango—a market structure where prompt prices are cheaper than contracts for future delivery, which signals surplus supplies and incentivizes inventory-building—since prices first began collapsing in late 2014, but spreads reversed course and moved decisively into backwardation in the closing quarter of 2017. Prompt WTI cargoes are currently commanding a $3/bbl premium (5%) compared to deliveries for next year as consumers scramble to secure supplies (chart 7).

METALS & MINERALS: TIGHTER BALANCES WITH ADDED MACRO SUPPORT

Metals market sentiment is closely related to the perceived health of the industrial sector and prices have rallied alongside global growth expectations. Base metals, in particular, have seen considerable gains since last summer, 20–40%, depending on the metal. Meanwhile, bulk commodities like iron ore that underpin the steel industry have seen more muted performance, down from last summer.

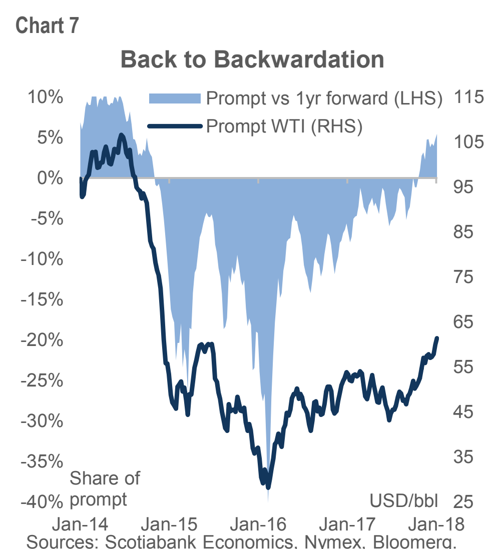
Some of the dislocation between industrial metals is due to the fact that while global growth appears to be synchronized across countries, the same cannot be said for growth across industries. Specifically, while manufacturing activity is roaring back to life in both advanced and developing economies, China's real estate and infrastructure investment

Chart 6



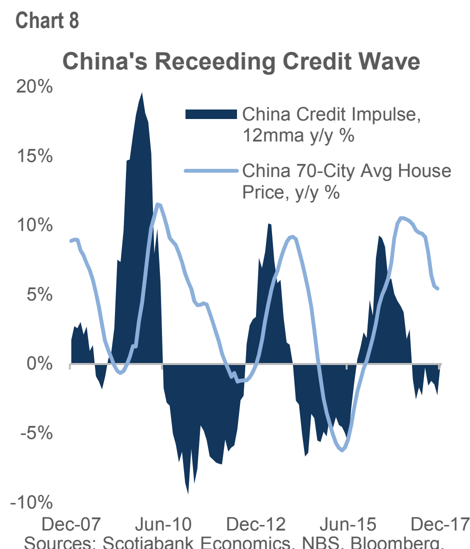
Sources: Scotiabank Economics, OPEC, OMI.

Chart 7



Sources: Scotiabank Economics, Nymex, Bloomerg.

Chart 8



Sources: Scotiabank Economics, NBS, Bloomberg.

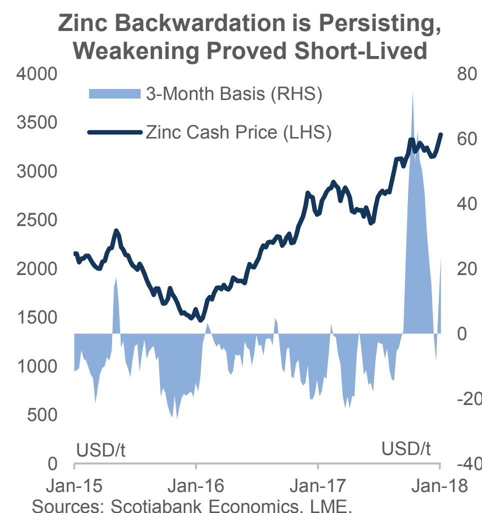
outlook is slowing as Chinese authorities withdraw stimulus from the economy (chart 8). Manufacturing growth, particularly in advanced markets, is good news for base metals demand as the output of home appliances and consumer electronics rises, but slower Chinese construction activity will weigh on steel-related commodities and may temper gains in commodities like copper that are heavily leveraged against building wiring as well as electrical transmission distribution infrastructure. In addition to the broad manufacturing support enjoyed by the base metals complex, the feverish sentiment building around electric vehicles has further boosted the prospects of battery-linked metals like nickel and cobalt as well as copper given its ubiquity in all things electric.

Within the metals complex, zinc maintains the strongest fundamentals and prices remain near their highest level in more than a decade. The arrival of acute fourth-quarter backwardation was the clearest signal yet of zinc's tightening physical market; a temporary move back toward contango in late-December proved short-lived and was likely more due to uneven positioning along the forward curve than a real loosening of spot market conditions (chart 9). Glencore has begun restarting some of the zinc mine capacity idled by the company in 2015 amid weak prices, though operations are expected to resume in a staggered manner and ramp-ups will be gradual, as previously alluded to by management statements. **We have lifted our zinc forecasts to $1.60/lb through 2018–19**, though prices are likely to jump far above those annual average levels when tightness becomes most acute later this year.

While still earlier in its rebalancing cycle than zinc, copper is the metal with the most improved fundamental outlook since our last quarterly outlook. **We now expect the red metal to average $3.05/lb in 2018 before gaining to $3.25/lb in 2019 as physical balances tighten, with near-term industry labour negotiations tipping risks to the upside**. Labour contracts underpinning more than one-fifth of global copper mine capacity in Chile and Peru are due to expire and will need to be renegotiated. This is the largest proportional supply-side labour renegotiation in almost a decade, and covers many large projects including Escondida (the world's largest copper project, 6% of global mine supply), Antamina, and Cerro Verde (~2% each). While most of these renegotiations will result in no production losses, it increases the odds that supply disruptions will be higher than average through 2018

Our gold forecast remains unchanged at $1300/oz through 2018-19, caught between the headwinds of rising global interest rates and the tailwinds of a secularly depreciating US dollar.

Chart 9



Sources: Scotiabank Economics, LME.

Table 1

Commodities	2000–2016			Annual Average			
	Low	Avg.	High	2016	2017	2018f	2019f
WTI Oil (USD/bbl)	17	63	145	43	51	57	60
Brent Oil (USD/bbl)	18	66	146	45	55	62	65
Nymex Natural Gas (USD/mmbtu)	1.64	4.94	15.38	2.55	3.02	2.95	2.95
Copper (USD/lb)	0.60	2.35	4.60	2.21	2.80	3.05	3.25
Zinc (USD/lb)	0.33	0.81	2.10	0.95	1.31	1.60	1.60
Nickel (USD/lb)	2.00	7.26	24.58	4.36	4.72	6.00	6.50
Aluminium (USD/lb)	0.56	0.86	1.49	0.73	0.89	0.95	1.00
Iron Ore (USD/tonne)	17	67	187	58	72	60	60
Metallurgical Coal (USD/tonne)	39	127	330	114	187	170	150
Gold, London PM Fix (USD/oz)	256	869	1,895	1,251	1,257	1,300	1,300

Sources: Scotiabank Economics, Bloomberg.

Foreign Exchange

US DOLLAR TO TRADE MORE DEFENSIVELY IN 2018

We are more convinced that the longer-term bull trend in the US dollar (USD) is poised to moderate or reverse following its poor overall performance over the course of 2017. While USD losses moderated into the end of last year, it closed out the year with a 10% loss versus its DXY (market-weighted) index, its weakest performance since 2003. Weak price action in the USD over the course of 2017 echoes market movement at previous, major secular USD peaks and supports our contention that medium- to longer-term risks are tilting lower for the USD overall.

The global economy continues to enjoy a broad upswing and central bank policy is becoming more active again; we think this situation will deliver a two-pronged assault on the USD. Firstly, faster growth elsewhere should draw investment flows away from the US economy, especially if US growth in the early part of the year disappoints again. Secondly, more active central bank policy elsewhere will tend to support their own currencies via higher interest rates—or market expectations thereof. We think additional pressure on the USD will stem from the perception of less political risk in the Eurozone whereas political risks may increase in the US. We also feel that the recent tax cut legislation in the US will do little to drive growth higher in 2018/19 but investors may start to focus on US structural imbalances—the USD's "Achilles Heel"—once again. Combined fiscal and external deficits are widening and weighing on the USD's performance which is usually bad news for the currency.

The Canadian dollar (CAD) rallied strongly in late 2017, reflecting a rebound in domestic inflation data (and markets pricing in the strong probability of a January rate increase by the Bank of Canada—BoC). CAD strength leaves us in something of a predicament as we are already at our year-end 2018 forecast point. We expect the CAD to retreat somewhat in the next few weeks on profit-taking if the BoC confirms our expectation of a rate hike (it will fall a bit further and quite a lot faster if tightening speculation is disappointed).

But we think scope for sustained CAD losses should be limited. Strengthening global growth momentum is helping bolster commodity prices and stronger commodities have helped propel the CAD higher in the last month or so. The rise in commodity prices and the resulting improvement in Canada's terms of trade are perhaps not yet fully reflected in the CAD, we feel. Higher commodity prices may give the CAD some protection from clear risks around the outlook (NAFTA, housing, etc.) which remain obvious, if hard to quantify at this point. In other words, the CAD may not be able to rally much more for now but we don't think it will fall too far either at the moment and expect it to remain well supported on dips overall this year.

The Euro (EUR) is trading near its highest in three years as the Eurozone economy continues to gain momentum. Recent PMI survey data suggests economic momentum has picked up to its strongest level since 2011. Inflation continues to lag, and the most recent data highlights the fact that price growth remains well below the European Central Bank's (ECB) 2% target. However, robust economic growth suggests that the European Central Bank will wind down

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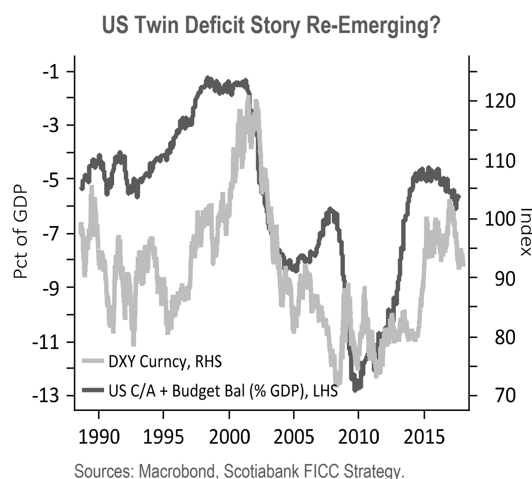
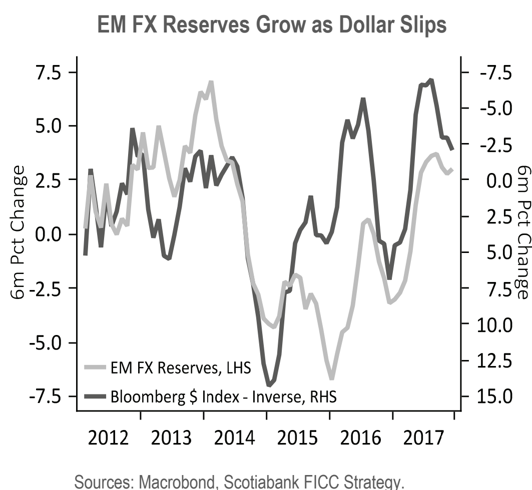
Chart 1



Sources: Macrobond, Scotiabank FICC Strategy.

Chart 2



Sources: Macrobond, Scotiabank FICC Strategy.

its asset purchase programme later this year regardless, even if rate hikes remain a 2019 story at this point. The past year was characterized by heightened political risk that focussed on a number of key, national elections in the Eurozone. All of these votes have passed, leaving the political centre—and pro-European consensus—largely intact. The looming Italian election, due on March 4th, had been seen as a potential constraint on the EUR but, with the major parties all backing the EUR, the risk of a significant shock has perhaps diminished. The EUR should benefit from capital being redeployed to Europe and global investors rebuilding exposure to the single currency again as political risks subside.

The pound (GBP) remains generally soft but has sustained a steady rise versus most major currencies, excluding the EUR, over the past year as the Brexit fall-out has been less severe than imagined in the immediate aftermath of the 2016 vote. Still, the economy is hardly robust; consumer demand and housing are two key sectors of the economy that look somewhat fragile amid weak real wage gains. UK inflation has been rising, partly due to the weak exchange rate, forcing the Bank of England (BoE) to tighten monetary policy modestly. We think further, modest rate increases are likely in 2018 to keep inflation in check but Brexit risks are likely to restrain the pound and uncertainty may still force the exchange rate back from current levels versus the USD. We maintain, however, that a pronounced drop in the GBP would leave the currency looking somewhat stretched in terms of its longer-run valuation.

We are bearish on the yen (JPY) and expect it to remain a relative under-performer in the major currency space this year. The JPY will remain vulnerable to firmer nominal yields elsewhere as we do not expect the Bank of Japan (BoJ) to alter its aggressively accommodative policy stance through 2018, given that domestic inflation at 0.6% remains very distant from the central bank's objective. Stronger global growth, rising global equity markets and a pervading sense of risk-seeking investment strategies suggest that "safe haven" demand for the JPY will remain muted for the moment as well.

Strengthening global growth trends are supportive of Asian Emerging Market FX broadly but regional central banks will be conscious of the need to remain regionally competitive with each other as exports recover. Strong current account surpluses are supportive of the Korean won, Thai baht and Taiwan dollar while rising export growth is supportive of the Malaysian ringgit, which we feel remains undervalued in nominal and real effective terms. We expect the Chinese yuan to rise modestly this year on rising foreign interest in yuan-denominated assets while high yields leave the Indonesian rupiah looking attractive. Markets appear to have discounted India's weaker fiscal position as recovering growth momentum supports the rupee. With the USD expected to remain on the defensive, Asian regional central banks may have to become a little more active in managing domestic currency appreciation in 2018. FX reserve accumulation may add more support to the EUR in the coming year as FX purchases are diversified into other currency holdings. We expect the Chinese yuan to trade narrowly around current levels in the early part of this year and appreciate modestly over the balance of 2018 towards 6.45 versus the USD.

The Mexican peso (MXN) ended 2017 on a soft note, falling back to near the 20 level amid continued uncertainty over trade relations with the US and the impact of US tax reform on domestic growth. Upward pressure on inflation should abate somewhat in early 2018 but markets continue to price in the risk of tighter monetary policy. However, in Mexico—and other regional economies—political developments are poised to influence exchange rate developments significantly in the coming year. Polling suggests the main candidates for Mexico's July presidential election are in a three-way tie at the moment. We expect the MXN to remain largely stable through 2018, however. We anticipate modest appreciation for the Peruvian sol (PEN) though domestic politics does inject some downside risks to the growth outlook which is somewhat contingent on public investment; we see USDPEN ending this year at 3.18. We expect the Chilean peso (CLP) to remain firm this year amid strengthening domestic growth and firm copper prices. Markets may also be influenced by the shape of incoming President Pinera's government. Pension reform and October's presidential election may keep the Brazilian real trading more defensively this year, however.

APPENDIX 1

International	2000–16	2016	2017e	2018f	2019f	2000–16	2016	2017e	2018f	2019f
	Real GDP (annual % change)					Consumer Prices (y/y % change, year-end)				
World (based on purchasing power parity)	3.9	3.2	3.7	3.8	3.6					
Canada	2.1	1.4	2.9	2.3	1.7	1.9	1.4	1.8	1.9	2.2
United States	1.9	1.5	2.3	2.5	1.8	2.2	1.8	2.0	2.2	2.4
Mexico	2.2	2.9	2.1	2.4	2.8	4.4	3.4	6.8	4.3	3.8
United Kingdom	1.8	1.9	1.8	1.5	1.9	2.0	1.6	3.0	1.9	1.9
Euro zone	1.3	1.8	2.4	2.7	2.5	1.7	1.1	1.5	1.5	1.5
Germany	1.3	1.9	2.6	3.0	3.0	1.5	1.7	1.6	1.6	1.9
France	1.3	1.2	1.9	2.5	2.0	1.6	0.8	1.2	1.5	1.5
China	9.4	6.7	6.8	6.5	6.2	2.3	2.1	1.8	2.5	2.6
India	7.1	7.9	6.3	7.4	7.5	6.9	3.4	4.9	4.6	5.7
Japan	0.9	0.9	1.8	1.4	0.9	0.1	0.3	0.8	1.1	2.3
South Korea	4.2	2.8	3.2	2.9	3.0	2.6	1.3	1.5	2.3	2.5
Australia	3.0	2.6	2.4	2.7	2.5	2.8	1.5	1.9	2.2	2.6
Thailand	4.0	3.2	3.8	3.5	3.4	2.0	1.1	0.8	1.7	2.1
Brazil	2.6	-3.5	0.6	2.5	2.7	6.7	6.3	4.0	4.1	2.6
Colombia	4.1	2.0	1.7	2.5	3.5	5.1	5.7	4.2	3.3	3.1
Peru	5.1	3.9	2.5	3.7	4.2	2.8	3.2	1.4	2.0	2.5
Chile	4.1	1.6	1.4	2.8	3.2	3.3	2.7	2.3	2.7	3.0
Commodities										
	(annual average)									
WTI Oil (USD/bbl)	63	43	51	57	60					
Brent Oil (USD/bbl)	66	45	55	62	65					
Nymex Natural Gas (USD/mmbtu)	4.94	2.55	3.02	2.95	2.95					
Copper (USD/lb)	2.35	2.21	2.80	3.05	3.25					
Zinc (USD/lb)	0.81	0.95	1.31	1.60	1.60					
Nickel (USD/lb)	7.26	4.36	4.72	6.00	6.50					
Aluminium (USD/lb)	0.86	0.73	0.89	0.95	1.00					
Iron Ore (USD/tonne)	67	58	72	60	60					
Metallurgical Coal (USD/tonne)	127	114	187	170	150					
Gold, London PM Fix (USD/oz)	869	1,251	1,257	1,300	1,300					

Sources: Scotiabank Economics, Statistics Canada, BEA, BLS, IMF, Bloomberg.

APPENDIX 2

North America	2000–16	2016	2017e	2018f	2019f	2000–16	2016	2017e	2018f	2019f
	Canada (annual % change, unless noted)					United States (annual % change, unless noted)				
Real GDP	2.1	1.4	2.9	2.3	1.7	1.9	1.5	2.3	2.5	1.8
Consumer spending	2.9	2.3	3.6	2.8	1.9	2.4	2.7	2.7	2.6	2.1
Residential investment	3.7	3.4	2.6	-0.8	-0.9	-0.4	5.5	1.3	1.8	1.7
Business investment	2.2	-8.8	1.5	3.6	2.6	2.3	-0.6	4.6	4.4	2.5
Government	2.2	2.7	2.1	1.8	1.0	1.0	0.8	0.0	0.5	0.4
Exports	1.3	1.0	1.0	2.3	3.2	3.6	-0.3	3.1	2.6	2.7
Imports	2.9	-1.0	3.3	2.4	2.7	3.4	1.3	3.3	2.8	3.2
Nominal GDP	4.2	2.0	5.1	4.3	4.0	3.9	2.8	4.1	4.4	3.8
GDP deflator	2.1	0.6	2.1	2.0	2.3	2.0	1.3	1.8	1.9	2.0
Consumer price index (CPI)	1.9	1.4	1.6	1.9	2.1	2.2	1.3	2.1	2.2	2.3
CPI ex. food & energy	1.6	1.9	1.6	1.8	2.0	2.0	2.2	1.8	2.1	2.2
Pre-tax corporate profits	3.6	-1.9	20.0	5.0	1.0	5.5	-2.1	5.0	4.4	0.5
Employment	1.3	0.7	1.9	1.5	0.8	0.7	1.8	1.5	1.3	1.0
Unemployment rate (%)	7.1	7.0	6.3	5.9	5.9	6.2	4.9	4.4	4.0	4.0
Current account balance (CAD, USD bn)	-17.1	-65.4	-66.8	-66.4	-60.1	-507	-452	-443	-450	-498
Merchandise trade balance (CAD, USD bn)	25.1	-25.9	-24.7	-27.4	-24.2	-673	-753	-797	-843	-910
Federal budget balance* (FY, CAD, USD bn)	-2.8	-1.0	-17.8	-16.8	-14.8	-532	-586	-666	-825	-935
percent of GDP	-0.2	0.0	-0.9	-0.8	-0.7	-3.7	-3.1	-3.4	-4.1	-4.5
Housing starts (000s, mn)	199	198	220	206	196	1.27	1.18	1.21	1.25	1.30
Motor vehicle sales (000s, mn)	1,657	1,949	2,038	2,000	1,950	15.5	17.5	17.1	17.4	17.3
Industrial production	0.6	0.1	5.2	2.0	1.1	0.7	-1.2	1.8	2.3	1.1
	Mexico (annual % change)									
Real GDP	2.2	2.9	2.1	2.4	2.8					
Consumer price index (year-end)	4.4	3.4	6.8	4.3	3.8					
Current account balance (USD bn)	-15.0	-27.9	-25.8	-31.1	-35.7					
Merchandise trade balance (USD bn)	-7.2	-13.1	-9.6	-10.5	-15.3					

Sources: Scotiabank Economics, Statistics Canada, CMHC, BEA, BLS, Bloomberg. * Canada ex risk adjustment of $1.5bn & $3.0bn for FY18 & FY19.

Quarterly Forecasts	2017		2018				2019			
Canada	Q3	Q4e	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Real GDP (q/q ann. % change)	1.7	2.0	2.6	2.2	1.9	1.9	1.6	1.6	1.5	1.5
Real GDP (y/y % change)	3.0	2.9	2.7	2.2	2.2	2.2	1.9	1.8	1.7	1.6
Consumer prices (y/y % change)	1.4	1.8	1.8	1.9	1.9	1.9	2.1	2.1	2.2	2.2
Avg. of new core CPIs (y/y % change)	1.5	1.7	1.7	1.8	1.9	1.9	2.0	2.0	2.0	2.0
United States										
Real GDP (q/q ann. % change)	3.2	2.8	2.4	2.2	2.1	1.9	1.6	1.6	1.6	1.6
Real GDP (y/y % change)	2.3	2.5	2.8	2.6	2.4	2.2	2.0	1.8	1.7	1.6
Consumer prices (y/y % change)	2.0	2.0	2.0	2.3	2.3	2.2	2.2	2.3	2.4	2.4
CPI ex. food & energy (y/y % change)	1.7	1.8	1.8	2.1	2.2	2.2	2.2	2.2	2.3	2.3

Sources: Scotiabank Economics, Statistics Canada, BEA, BLS, Bloomberg.

APPENDIX 3

Central Bank Rates	2017 Q4	2018 Q1f	2018 Q2f	2018 Q3f	2018 Q4f	2019 Q1f	2019 Q2f	2019 Q3f	2019 Q4f
Americas				(%, end of period)					
Bank of Canada	1.00	1.25	1.50	1.50	1.75	2.00	2.25	2.25	2.50
US Federal Reserve (upper bound)	1.50	1.75	1.75	2.00	2.25	2.25	2.50	2.50	2.75
Bank of Mexico	7.25	7.50	7.50	7.50	7.75	7.75	7.50	7.25	7.00
Central Bank of Brazil	7.00	6.75	6.50	6.50	6.75	7.00	7.50	8.00	8.50
Bank of the Republic of Colombia	4.75	4.75	4.50	4.50	4.50	4.75	5.00	5.00	5.00
Central Reserve Bank of Peru	3.25	2.75	2.75	2.75	2.75	3.00	3.00	3.25	3.25
Central Bank of Chile	2.50	2.50	2.75	3.00	3.25	3.50	3.50	3.75	3.75
Europe									
European Central Bank	0.00	0.00	0.00	0.00	0.00	0.00	0.25	0.25	0.50
Bank of England	0.50	0.50	0.75	0.75	1.00	1.00	1.25	1.50	1.50
Asia/Oceania									
Reserve Bank of Australia	1.50	1.50	1.50	1.50	1.75	1.75	2.00	2.00	2.25
Bank of Japan	-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	4.60	4.60	4.85	4.85
Reserve Bank of India	6.00	6.00	6.00	6.00	6.00	6.25	6.25	6.50	6.50
Bank of Korea	1.50	1.50	1.75	1.75	2.00	2.00	2.25	2.25	2.25
Bank of Thailand	1.50	1.50	1.50	1.75	1.75	2.00	2.00	2.25	2.25
Currencies and Interest Rates									
Americas				(end of period)					
Canadian Dollar (USDCAD)	1.26	1.28	1.27	1.26	1.25	1.25	1.22	1.22	1.25
Canadian Dollar (CADUSD)	0.80	0.78	0.79	0.79	0.80	0.80	0.82	0.82	0.80
Mexican Peso (USDMXN)	19.66	19.28	19.13	19.19	19.48	19.58	19.40	19.45	19.73
Brazilian Real (USDBRL)	3.31	3.45	3.50	3.55	3.60	3.55	3.55	3.50	3.50
Colombian Peso (USDCOP)	2,986	3,100	3,100	3,050	3,000	3,000	3,050	3,100	3,100
Peruvian Nuevo Sol (USDPEN)	3.24	3.22	3.19	3.20	3.18	3.18	3.14	3.15	3.12
Chilean Peso (USDCLP)	615	606	608	609	610	608	605	602	599
Europe									
Euro (EURUSD)	1.20	1.18	1.18	1.20	1.20	1.24	1.24	1.28	1.28
UK Pound (GBPUSD)	1.35	1.35	1.35	1.37	1.37	1.38	1.38	1.40	1.40
Asia/Oceania									
Japanese Yen (USDJPY)	113	114	114	115	115	118	118	120	120
Australian Dollar (AUDUSD)	0.78	0.79	0.79	0.80	0.80	0.81	0.81	0.82	0.82
Chinese Yuan (USDCNY)	6.51	6.50	6.50	6.45	6.45	6.40	6.40	6.30	6.30
Indian Rupee (USDINR)	63.9	63.0	63.0	62.0	62.0	61.0	61.0	60.0	60.0
South Korean Won (USDKRW)	1,067	1,060	1,060	1,040	1,040	1,030	1,030	1,020	1,020
Thai Baht (USDTHB)	32.6	32.2	32.2	32.0	32.0	31.5	31.5	31.0	31.0
Canada (Yields, %)									
3-month T-bill	1.06	1.30	1.55	1.55	1.80	2.05	2.30	2.30	2.50
2-year Canada	1.69	1.90	2.05	2.20	2.30	2.40	2.50	2.55	2.65
5-year Canada	1.87	2.05	2.15	2.30	2.45	2.55	2.60	2.65	2.75
10-year Canada	2.05	2.20	2.30	2.45	2.60	2.65	2.70	2.75	2.85
30-year Canada	2.27	2.35	2.50	2.75	2.90	3.00	3.10	3.15	3.10
United States (Yields, %)									
3-month T-bill	1.38	1.80	1.80	2.05	2.30	2.30	2.55	2.60	2.80
2-year Treasury	1.88	2.20	2.30	2.50	2.60	2.70	2.75	2.85	2.90
5-year Treasury	2.21	2.50	2.60	2.70	2.75	2.85	2.90	3.00	3.05
10-year Treasury	2.40	2.70	2.80	2.85	2.90	3.00	3.05	3.15	3.20
30-year Treasury	2.74	2.85	2.95	3.00	3.05	3.15	3.20	3.30	3.35

Sources: Scotiabank Economics, Bloomberg.

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