Rising Momentum Trumps Policy Uncertainty

- **Growth is accelerating as household spending and business activity continue to improve globally.**
- **Risks of a policy-induced shock to global growth coming from the US have diminished.**

The global economy continues to improve (chart 1). Strong macroeconomic data in many parts of the world confirm that growth is firming, and that both households and business have become increasingly confident. Job growth remains high, there are signs that investment activity is picking up across a range of countries, and there is clear evidence of strengthening activity in the manufacturing sector, particularly in the US and Canada. Greater business activity (chart 2) is leading to increased trade across the world (chart 3), which is now set to rise at its fastest rate since 2011. On the household side, there is perhaps no greater indicator of the strength of consumer finances and optimism than purchases of motor vehicles (chart 4), which continue to track higher for the global economy (excluding China, in which a special tax rebate distorted motor vehicle sales last year).

The strength in incoming data trumps the policy risks coming from the US. It now appears that the Trump Administration is less likely to move forward with extreme protectionist policies as well as the destination-based cash flow tax (which includes the border tax adjustment). These risks remain, of course, and others still weigh on the outlook, such as potential developments in North Korea. Because of this, we remain of the view that political and geo-political risks dominate economic risks.

The US economy remains in a sweet spot of accelerating growth (chart 5), moderate price pressures, improving labour markets, robust consumer demand, increasing manufacturing orders, and rising investment. At this time, there is little evidence that concerns about potential policy actions in the US are having a negative influence on the economy. Rather, the opposite is occurring as consumer confidence has reached its highest level since 2000, and purchasing manager indices are well into expansionary territory. The strength of the recovery has led the Federal Reserve to increase interest rates twice since last autumn, and we expect rates to be raised by another 50 basis points by the end of this year. If economic indicators in the US remain as robust as we have seen in the last few months, it is conceivable that the Fed may need to be more aggressive in its attempts to cool the economy.

The Canadian outlook has improved further as housing continues to surprise on the upside. Strong growth in the US, higher commodity prices, low interest rates, fiscal stimulus, and extremely strong job growth continue to be powerful drivers of growth. Investment in oil and gas production is showing renewed strength, but low economy-wide investment continues to hold back non-energy exports. Execution on public-infrastructure spending is ongoing, but at a more moderate pace than planned, so we have scaled back the expected contribution from fiscal policy to growth to 0.4 from 0.5 percentage points in our previous forecast. Despite this adjustment, private sector momentum is sufficiently strong that we have

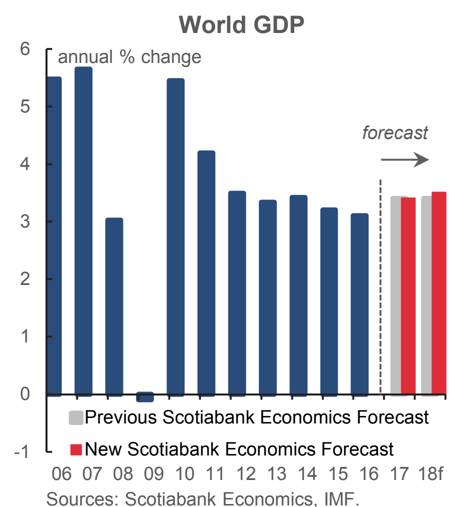
CONTACTS

Jean-François Perrault, SVP & Chief Economist
416.866.4214
Scotiabank Economics
jean-francois.perrault@scotiabank.com

CONTENTS

Overview	1–3
Canada	4–8
The Provinces	9–10
United States	11–15
US & Canadian Monetary Policy & Capital Markets	16–19
Mexico	20–21
United Kingdom	22–23
Eurozone	24–25
Latin America	26–35
Asia	36–40
Commodities	41–43
Foreign Exchange	44–45
Summary Forecast Tables	A1–A3

Chart 1



Sources: Scotiabank Economics, IMF.

nevertheless raised our growth forecast for 2017. Important risks remain. The long-awaited recovery in investment may be further delayed by trade-related policy uncertainty in the US, even though we assess these risks to be receding. While we do not anticipate a major correction in GTA housing markets given the strength of fundamentals, there are clear downside risks. Inflationary pressures are less intense in Canada than in the US, and we continue to believe the Bank of Canada will remain on hold until mid-2018 even though markets are now pricing a significant chance that the Bank of Canada will raise rates by the end of 2017. The continued divergence of Canadian and US monetary policies should result in a weakening Canadian dollar through the first half of the year.

Chart 2

Sources: Scotiabank Economics, Netherlands Bureau for Economic Policy Analysis.

Chart 3

Sources: Scotiabank Economics, CPB Netherlands Bureau for Economic Policy Analysis.

The economies of the Pacific Alliance Countries will underperform this year, reflecting a number of factors. In Mexico, NAFTA-related uncertainties are having an impact on business investment, though some of this uncertainty is abating (witness the sharp rebound in the peso this year). The reform of Pemex is also affecting oil investment and output. Setting these factors aside, however, large segments of the Mexican economy are doing well. Employment growth is strong, as is activity in the export sector, along with retail sales. Industrial production, excluding oil and heavy construction, is on an upward trend. In Chile, the mining and business sectors continue to struggle, compounded in part by a strike at a large copper mine. The late-2017 election has the potential to significantly improve the outlook if a more business-oriented candidate wins. In Peru, El Niño is having a large impact on growth, which is compounded by delayed infrastructure spending given a number of legal and political challenges. Reconstruction from the floods and a likely resumption of some infrastructure investments should contribute to a strong rebound in 2018. In Colombia, growth will remain below its potential given structural challenges, but a sharp rebound is expected in 2018. Assessment of the impact of the early-April mudslides on the Colombian economy is ongoing.

In the UK, growth is cooling owing to the rise in inflation, which is linked to the depreciation of the pound, and the impact it has had on real incomes. The export sector continues to do well given the strength of foreign demand and the gain in competitiveness from the weaker currency. The triggering of Article 50 is unlikely to have major new consequences for the outlook, but uncertainty will remain high and there is the potential for a more negative impact on the economy as negotiating positions become clear. Growth in mainland Europe continues to strengthen despite the challenging political calendar. Business and consumer confidence measures point to a strong acceleration of growth, and credit expansion is now at its strongest level since 2009. Accommodative

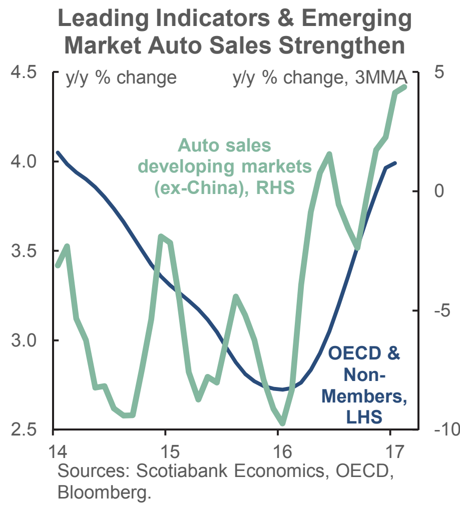
Table 1 — Global Real GDP

	2000–15	2016e	2017f	2018f
		(annual % change)		
World (PPP)	3.9	3.1	3.4	3.5
Canada	2.2	1.4	2.3	2.0
United States	1.9	1.6	2.3	2.4
Mexico	2.4	2.3	1.4	2.1
United Kingdom	1.8	1.8	2.0	1.2
Euro zone	1.2	1.6	1.7	1.7
Germany	1.2	1.7	1.8	1.7
France	1.3	1.2	1.4	1.6
Russia	4.6	-0.2	1.2	1.4
China	9.8	6.7	6.4	6.0
India	7.0	7.6	7.5	7.8
Japan	0.9	1.0	1.1	0.7
South Korea	4.4	2.8	2.5	2.6
Indonesia	5.6	5.0	5.3	5.5
Australia	3.0	2.5	2.5	2.6
Thailand	4.2	3.2	3.2	3.2
Brazil	3.4	-3.6	0.5	2.0
Colombia	4.3	2.0	2.1	3.2
Peru	5.3	3.9	2.9	3.7
Chile	4.3	1.6	1.8	2.4

monetary policy is still required to sustain positive momentum, though the ECB is signalling increased confidence in the recovery. An interest rate hike is unlikely this year, though we do think it likely that the ECB will consider tapering its asset purchase program around mid-year.

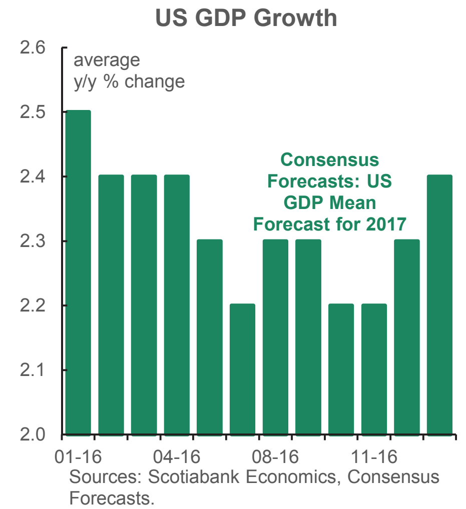
In Asia, growth in the major economies remains solid. High-frequency indicators in China imply the economy is off to a solid start in 2017, though the ongoing structural transformation of the economy will continue to act as a drag on growth. China—and the US—remain vulnerable to any changes in trade policy emanating from Washington, but other risks remain in the housing sector and the high level of corporate debt. In Japan, growth is anticipated to be around 1% annually in 2017 and 2018, which will be somewhat above trend. Growth remains fuelled by a strengthening global economy, with domestic demand continuing to rely on policy support. In the absence of a more determined structural reform effort, growth will slow over the medium-term.

Chart 4



Sources: Scotiabank Economics, OECD, Bloomberg.

Chart 5



Sources: Scotiabank Economics, Consensus Forecasts.

Canada

- **Growth continues to accelerate into 2017, but the sources of this strengthening performance are proving somewhat different than we anticipated a quarter ago.**
- **Despite our previous expectations that housing and auto sales would begin to provide a mild drag on Canadian growth in 2017, both sectors continue to add to Canada's improving outlook. Investment in oil and gas drilling is showing renewed strength, but long-awaited improvements in economy-wide investment and non-energy exports have yet to gain traction, and execution on public-infrastructure spending is ongoing, but at a more moderate pace than planned.**
- **Investment will continue to be inhibited by uncertainty surrounding NAFTA and the prospect of US business-tax reform, but a widening US-Canada policy-rate differential and weaker CAD should help cushion any hit to Canadian competitiveness.**
- **Macroeconomic fundamentals remain supportive for Canada's key housing markets in 2017, but we expect a mild slowing in 2018 as interest rates rise and affordability becomes more constraining.**

GROWTH CONTINUES ACCELERATING INTO 2017 BY FIRING THE SAME CYLINDERS

The Canadian economy continued to strengthen through early-2017, but the sources of Canada's accelerating growth are proving somewhat different from those we anticipated three months ago. In the hand-off from 2016, we expected increasing affordability concerns to weigh on housing and auto sales, while record household indebtedness and rising interest rates would likely dampen consumption growth. We projected these mild drags would be offset by firming investment, growing non-energy exports, and follow-through on public-infrastructure plans. In the event, housing, auto sales, and consumption growth haven't slowed, while business capital spending and non-energy exports haven't picked up, and public-infrastructure spending is delayed.

Rather than firing on all cylinders, the main drivers of the Canadian economy remain unchanged and imbalanced—so much so that our growth projection for 2017 has been pushed upward from 2.0% to 2.3% (table 2). Growth in 2018 remains at 2.0% on our continued expectation that the sources of Canadian GDP expansion will begin shifting and diversifying during the year ahead, reducing the economy's reliance on housing and consumption, and increasing the contribution of investment and exports to growth (table 2).

BETTER LABOUR MARKET AND PUBLIC TRANSFERS SUSTAIN CONSUMPTION

Consumer fundamentals remain relatively favourable, and should keep household spending growth just north of 2% in 2017 as labour markets continue to strengthen. Monthly job gains averaged 36,000 from August 2016 through

CONTACTS

Brett House, VP & Deputy Chief Economist
416.863.7463
Scotiabank Economics
brett.house@scotiabank.com

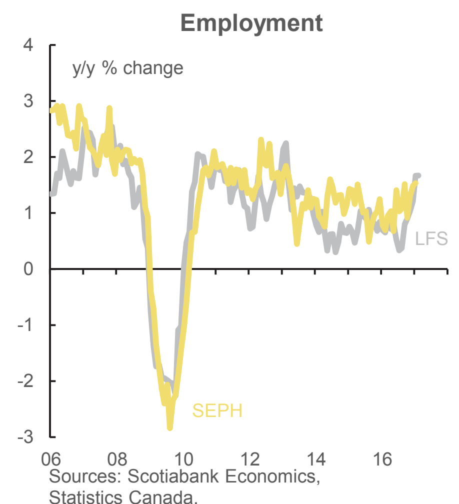
Carlos Gomes
416.866.4735
Scotiabank Economics
carlos.gomes@scotiabank.com

Neil Tisdall
416.866.6252
Scotiabank Economics
neil.tisdall@scotiabank.com

Adrienne Warren
416.866.4315
Scotiabank Economics
adrienne.warren@scotiabank.com

Mary Webb
416.866.4202
Scotiabank Economics
mary.webb@scotiabank.com

Chart 1



Sources: Scotiabank Economics, Statistics Canada.

February 2017, the strongest seven-month tally in nearly a decade, led by the service sector. While labour-market surveys occasionally produce false signals, both household and payroll reports confirm the recent pickup in hiring (chart 1). These employment gains have tilted back in favour of full-time positions, which mirrors recent improvements in business sentiment (chart 2).

The headline jobs numbers belie somewhat more muted details in the Canadian labour market. Total hours worked have fallen over the past year, and wage growth continues to decelerate. Adjusted for inflation, average hourly earnings have dropped over the past twelve months—which implies ongoing labour-market slack. Participation rates remain near decade lows at just under 66%.

Despite slowing wage growth, household income growth remains solid, supported in part by increased government transfers from the Canada Child Benefit and other targeted federal and provincial programmes. Building upon recent hikes, legislated increases to minimum wages are expected in a number of provinces during 2017–18. Consumer confidence indicators have hit their highest levels since 2010 and major purchase plans have firmed up alongside expectations of improving household finances.

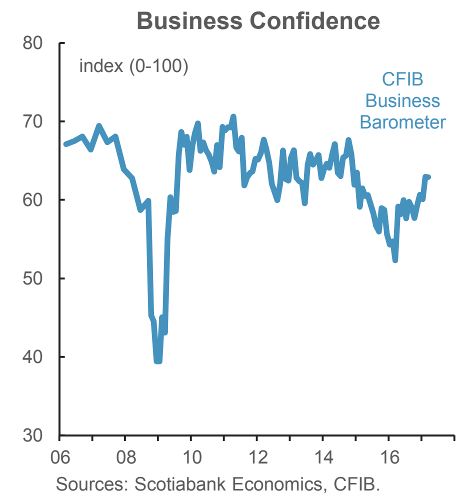
Ongoing gains in housing wealth combined with rising equity prices also support moderate growth in consumption (chart 3). We estimate that gains in net housing equity have added upward of 0.7 percentage points annually to household spending growth in recent years, assuming a standard wealth effect of five cents on the dollar. Rising household wealth is also likely a key factor underpinning a surge in luxury-vehicle sales in recent months that has been concentrated in BC and Ontario.

Domestic consumption trends are also getting a lift from a narrowing tourism deficit, as the weaker CAD deters cross-border shopping trips by Canadians and attracts more foreign tourism dollars to Canada. The number of Canadian same-day car trips to the United States has fallen sharply since 2013, while the number of international tourists to Canada has climbed steadily higher (chart 4).

Even so, we continue to forecast a period of somewhat softer consumption growth heading into 2018. Higher income taxes on upper-income earners alongside higher gasoline prices and newly-implemented carbon taxes are expected to sap some individuals' purchasing power. There are also emerging signs that Canadian households are taking a more cautious approach to debt accumulation: household credit growth has decelerated modestly over the past six months, led by slowing mortgage demand. The household savings rate has edged up to nearly 6%, which suggests that families are building larger financial cushions amid high debt loads and rising interest rates.

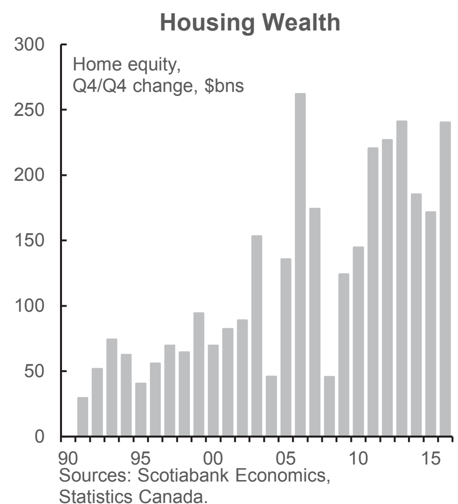
Sales of vehicles, amongst other big-ticket items, are expected to edge lower this year alongside recent price increases for new cars and light trucks, and weaker demographic trends. The number of potential vehicle buyers is expected to increase at the slowest pace in several decades, as an increasing number of Baby-Boomers age past their vehicle-buying years without complete replacement by Millennials. Purchases of housing-related goods such as furniture, appliances, and building materials, which have recently boosted consumer spending, also are forecast to moderate as real-estate prices and lack of affordability (finally) slow housing-market growth, beginning in the latter part of 2017.

Chart 2



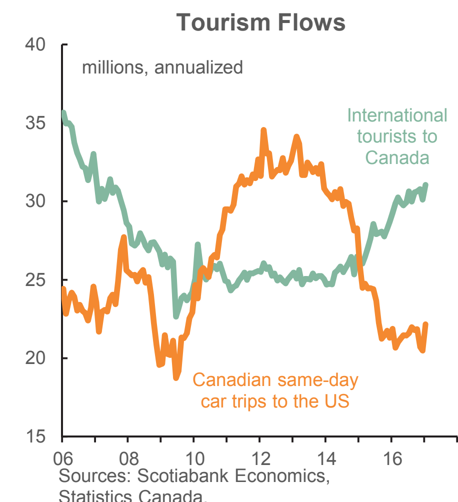
Sources: Scotiabank Economics, CFIB.

Chart 3



Sources: Scotiabank Economics, Statistics Canada.

Chart 4



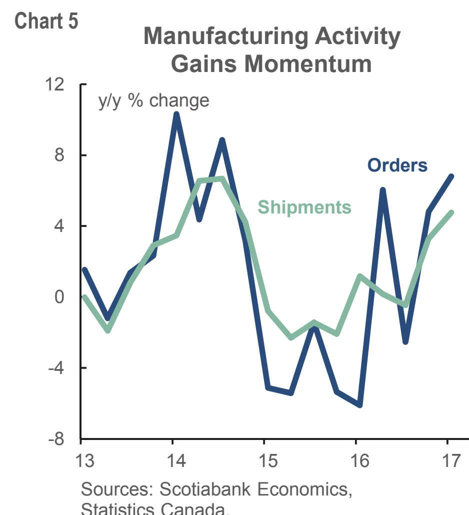
Sources: Scotiabank Economics, Statistics Canada.

HOUSING: TORONTO REMAINS ON A TEAR

Residential investment remains an uncomfortably-large contributor to Canadian growth, with national home sales still tracking near record highs in early 2017. While national housing-sales numbers are dominated by red-hot markets in Toronto, its surrounding communities, and parts of BC, including Victoria and Kelowna, the recent housing downturns in oil-producing regions and Vancouver appear to be stabilizing. Meanwhile, homebuilders are signaling even stronger construction intentions than last year's elevated levels. Based on the ongoing strength in permit demand, we have upgraded our forecast for housing starts to total 195,000 units in 2017, only marginally below last year's tally.

We expect a combination of deteriorating affordability, recently-introduced policy measures at the national level and in BC, possible additional action from the Ontario government, and modestly higher borrowing costs to gradually slow home sales and price appreciation this year. Supply constraints will, however, continue to bind in many large, urban centres during the coming years, as we argued in our recent report on options to deal with the GTA Housing Market. Demand is also likely to remain sustained by strengthening labour markets, increasing immigration, and the ageing of millennials into the core house-buying years.

Chart 5

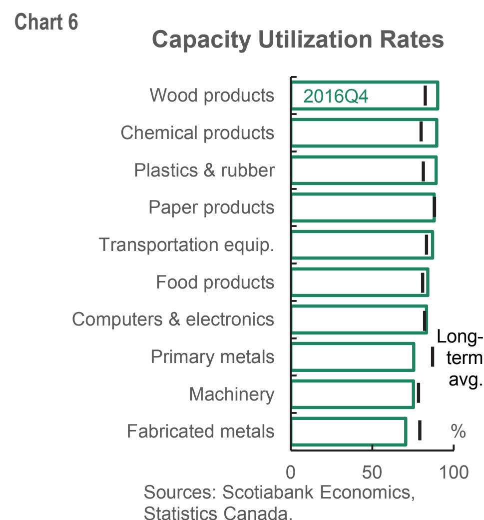


Sources: Scotiabank Economics, Statistics Canada.

MANUFACTURING BEGINS TO TREND HIGHER

While Canadian non-energy exports remain weak, total orders and shipments have started to rebound (chart 5) and freight data indicate that trucking and rail traffic are finally on the upswing, pointing to a firmer tone in industrial activity in the months ahead. In particular, new orders for manufactured goods jumped 8% between August 2016 and the opening month of 2017, the largest five-month increase in nearly two years. This implies that the ongoing revival in US demand may finally be sufficiently large and sustained to provide a much-needed lift to Canadian industrial producers, which export more than half of their manufactured goods to the United States. Overall, the US accounts for about three-quarters of Canadian exports.

Chart 6



Sources: Scotiabank Economics, Statistics Canada.

Table 1 — Quarterly Canadian Forecasts

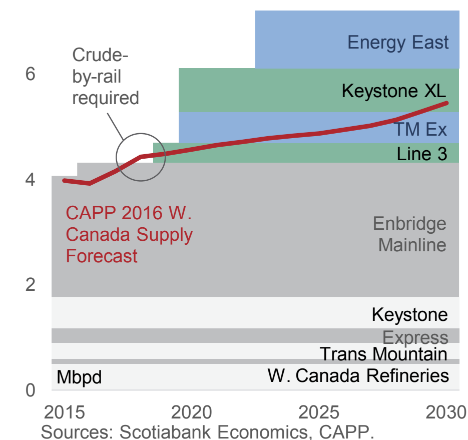
	2016				2017				2018			
	Q1	Q2	Q3	Q4	Q1e	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Economic												
Real GDP (q/q ann. % change)	2.7	-1.2	3.8	2.6	2.8	2.0	2.1	2.1	2.0	2.0	1.9	1.9
Real GDP (y/y % change)	1.3	1.1	1.4	1.9	2.0	2.8	2.3	2.2	2.0	2.0	2.0	2.0
Consumer Prices (y/y % change)	1.5	1.6	1.2	1.4	2.0	2.1	2.3	2.1	1.9	1.9	2.1	2.1
Core CPI (y/y % change)	2.0	2.1	1.9	1.6	1.7	1.7	1.8	1.8	1.9	1.9	1.9	1.9
Financial												
Canadian Dollar (USDCAD)	1.30	1.29	1.31	1.34	1.33	1.40	1.38	1.36	1.36	1.34	1.32	1.30
Canadian Dollar (CADUSD)	0.77	0.77	0.76	0.74	0.75	0.71	0.72	0.74	0.74	0.75	0.76	0.77
Bank of Canada Overnight Rate (%)	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.75	0.75	1.00
3-month T-bill (%)	0.45	0.49	0.53	0.46	0.55	0.50	0.50	0.50	0.60	0.80	0.90	1.10
2-year Canada (%)	0.54	0.52	0.52	0.75	0.75	0.85	0.95	1.05	1.20	1.35	1.45	1.60
5-year Canada (%)	0.68	0.57	0.62	1.11	1.12	1.25	1.35	1.40	1.50	1.65	1.80	1.90
10-year Canada (%)	1.23	1.06	1.00	1.72	1.63	1.75	1.85	1.90	1.95	2.10	2.20	2.35
30-year Canada (%)	2.00	1.72	1.66	2.31	2.30	2.35	2.45	2.50	2.55	2.65	2.75	2.80

Increased orders for machinery, computers, and electronic equipment are leading the way, having surged nearly 20% since the opening month of 2016, one of the fastest year-on-year increases since the years of the tech boom in the late 1990s. These sectors account for roughly 30% of all manufacturing shipments and are amongst the most export-intensive industries. Further sales growth in these sectors may be hampered, however, by capacity constraints that cannot be immediately resolved until new investment is undertaken in the years ahead (chart 6).

IMPROVING GOODS AND SERVICES EXPORTS

Firmer US demand and rising manufacturing orders reinforce our expectation that non-energy export growth will finally experience a long-awaited acceleration in 2017 and into 2018—though data from the beginning of 2017 don't yet point to early signs of an upturn.

Chart 7



Sources: Scotiabank Economics, CAPP.

Petroleum product shipments, which account for about a fifth of total Canadian exports, have firmed in recent months and will continue to improve through 2018 following the 2016 wildfire disruptions. As projects sanctioned during past high-price environments come on-stream (e.g., Fort Hills), Western Canadian production is forecast to briefly outstrip available pipeline capacity in 2018 before new pipeline capacity comes online (i.e., Line 3 replacement, chart 7). Higher-cost rail transport is expected to temporarily widen Canadian crude discounts relative to WTI, though total export value will continue to rise alongside global crude prices.

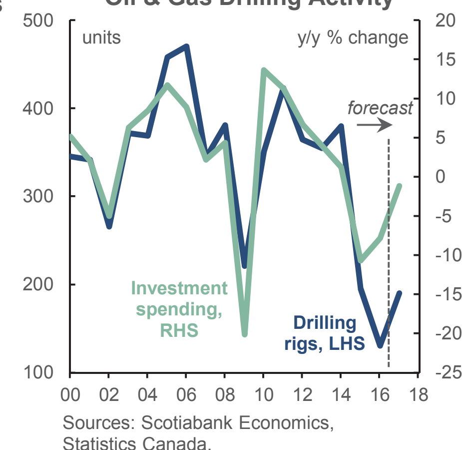
Canadian service exports grew 4% in 2016 compared with only a 0.5% increase in goods exports. Tourism, as noted above, and transportation-services exports were particularly strong heading into 2017, with both posting double-digit gains in the fourth quarter of 2016, supported by a relatively weak CAD, low transportation costs as fuel prices remain subdued, and tourism diversion from the US in the face of tighter visa requirements and vetting procedures.

US moves to re-open and renegotiate the North American Free Trade Agreement (NAFTA) may be limited to 'tweaks' and deferred to late-2017 or 2018 as the US administration grapples with more immediate policy priorities, including business-tax reform. The Ryan-Brady destination-based, cash-flow tax with border adjustment—one of the tax options that would have a negative effect on Canadian exporters—is unlikely to feature in an eventual reform package owing to its complicated design, opposition to it from import-intensive sectors, and its inconsistency with existing trade treaties. Instead, the US authorities are likely simply to cut the existing corporate tax rate. The Canadian forestry sector will, however, continue to face particular uncertainty from the possibility of countervailing duties and anti-dumping levies until a replacement for the now-expired Softwood Lumber Agreement (SLA) is in place.

INVESTMENT SET TO GROW

Strengthening demand for manufactured goods and exports when several key sectors face capacity constraints bodes well for a progressive upturn in business investment. Historically, Canadian business investment spending begins to respond to stronger exports with a roughly two-quarter lag, which conditions our expectation that business investment will stop contracting later in 2017 and return to growth in 2018. The 50% year-over-year rebound in oil drilling activity in the opening months of 2017 is also positive for the investment outlook, as the oil and gas sector has accounted for more than 20% of business investment in recent years and has led overall investment activity (chart 8).

Chart 8



Sources: Scotiabank Economics, Statistics Canada.

Despite these positive fundamentals, a rebound in business investment may be delayed by the ongoing uncertainty surrounding access to the US market under NAFTA and the prospect that a lower US corporate tax-rate could hurt the competitiveness of Canadian industry. A widening US-Canada monetary policy-rate differential and a weaker CAD should cushion the blow of developments in the United States. Still, a northward drift of higher US rates could also curb Canadian investment just as conditions are aligning for capital spending to take off.

FISCAL STIMULUS ROLLING OUT, BUT MORE SLOWLY

The Federal government's current and capital expenditures will likely be delivered more smoothly and more gradually than initially announced. As a result, the public sector's contribution to Canada's real GDP will remain at 0.4 percentage points from 2015 all the way through to 2018. This will take public spending from contributing almost half of Canada's total growth to about a fifth in 2018 as the rest of the economy strengthens.

Phase 1 of the federal government's infrastructure plan remains set to ramp up over the course of 2017 and into 2018. In total, it will focus about CAD 12 bn of capital spending on green and social infrastructure plus public transit, with already-announced investments in post-secondary institutions and rural broadband adding a further CAD 2.5 bn. Provincial and municipal governments are actively setting aside matching funds for their share of these joint investments.

Delays are also anticipated in Phase 2 of the Trudeau government's plan, which implies that the federal public sector's contribution to Canadian growth will likely remain elevated above past cyclical norms into 2019. This may be partially offset, however, by ongoing reviews of other existing federal programmes that are intended to free resources for the 2017 budget's commitments to new skills training and innovation initiatives.

In contrast with the federal government, the Provinces continue to prioritize operating expenditures to meet fiscal constraints. Entering fiscal year 2018, four Provinces are further restraining outlays and/or increasing revenues to accelerate the elimination of their deficits. Conversely, BC and Quebec, with balanced books, are offering annual instalments on tax relief.

MAJOR RISKS ABATING

The balance of risks to the Canadian outlook is improving. US demand for Canadian goods and services continues to strengthen and overall US growth is becoming more broadly based and accelerating, making the US economy—and by extension the Canadian economy—less vulnerable to political hiccups in Washington, DC. Canadian housing, auto sales, and major components of consumption are performing better than anticipated at the time of the last *Quarterly Outlook*. On the downside, the Canadian economy remains highly dependent on real estate and consumption: the baton has not yet been passed decisively to investment and exports to sustain Canadian growth. A sharper-than-expected rise in borrowing costs would squeeze indebted households, while a swift correction in the country's major housing markets would have an even greater negative impact on the entire economy. But compared with three months ago, it now looks far less likely that NAFTA will be subjected to major revisions or that US business taxes will be reformed in a way that would seriously erode Canada's relative competitiveness. On balance, the prospects for Canada look even sunnier than at the beginning of 2017.

Table 2 — Canada

	2000–15	2016	2017f	2018f
	(annual % change, unless noted)			
Real GDP	2.2	1.4	2.3	2.0
Consumer Spending	2.9	2.2	2.2	1.7
Residential Investment	3.8	2.8	1.1	-1.0
Business Investment	2.7	-7.8	-1.1	3.0
Government	2.2	1.9	2.0	2.0
Exports	1.3	1.1	2.3	3.7
Imports	3.1	-1.0	0.7	2.9
Nominal GDP	4.4	2.0	4.7	4.0
GDP Deflator	2.2	0.6	2.3	2.0
Consumer Price Index (CPI)	2.0	1.4	2.1	2.0
Core CPI (CPIX)	1.8	1.9	1.7	1.9
Pre-Tax Corporate Profits	3.9	-4.5	11.0	5.0
Employment	1.4	0.7	1.3	0.8
Unemployment Rate (%)	7.1	7.0	6.7	6.6
Current Account Balance (CAD bn)	-13.9	-67.7	-45.6	-34.2
Merchandise Trade Balance (CAD bn)	28.2	-25.9	-1.3	7.2
Federal Budget Balance (FY, CAD bn)	-2.9	-1.0	-23.0	-28.5
percent of GDP	-0.2	0.0	-1.1	-1.3
Housing Starts (000s)	199	198	195	185
Motor Vehicle Sales (000s)	1,639	1,949	1,940	1,925
Industrial Production	0.5	-0.3	2.5	1.7
WTI Oil (USD/bbl)	64	43	53	56
Nymex Natural Gas (USD/mmbtu)	5.09	2.55	3.10	3.05

The Provinces

THE GRADUAL REBALANCING OF GROWTH WITHIN REGIONS

- **Solid economic gains across Canada are forecast for 2017, providing momentum for 2018. Non-energy goods & services exports specific to each province are gaining traction, and the oil industry is gradually recovering.**
- **In fiscal 2016–17 (FY17), just completed, the seven net oil-consuming Provinces' combined deficit narrows towards CAD 1 bn (from their FY10 CAD 25½ bn record shortfall) which helps to accommodate elevated infrastructure investment.**

Multiple trends are driving the Provinces' economic expansion this year. Diverse benefits are emerging from a strengthening US economy, a competitive Canadian dollar vis-à-vis its US counterpart, low interest rates and commodity prices moving off recent lows.

All provinces entered 2017 with y/y population gains as each jurisdiction shared in the national 9.0% upswing in international immigration. For the three major oil-producing provinces, immigration compensated for steepening net out-migration to other provinces. Alberta and Saskatchewan, with the added strength of positive natural increase, are presently sustaining 1.5% y/y population growth. Job creation this year, surging from December to February, is expected to pace rising regional populations. Seasonally adjusted labour force participation rates in early 2017 are higher than last summer in six provinces, with notable increases in the four largest provinces reversing some of the post-recession decline. In Quebec and Ontario, the number of unemployed 27 weeks or longer has fallen 19.0% in the past two years.

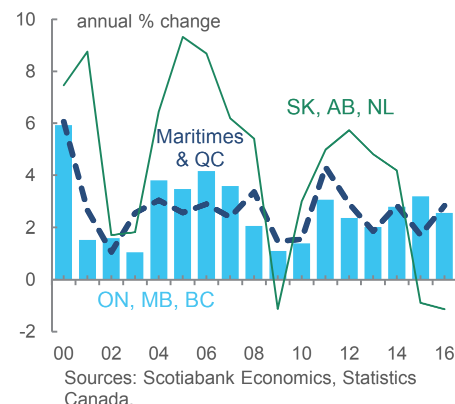
In part due to lower oil prices, compensation per employee (including employers' social contributions) in the net oil-consuming provinces is expected to exceed subdued inflation again in 2016, building on the prior year's real gain (chart 1). For the major oil–producing provinces, the slow upturn anticipated in wages is expected to limit their consumption growth over the next two years. Residential construction in Manitoba and east of Ontario is expected to stabilize or rise this year after a soft landing during the past three years. Some easing in Ontario's current hot housing markets is expected to account for much of the 2018 correction in national starts. In Alberta and Saskatchewan, non-energy industries are expected to lag the petroleum sector's measured turnaround, while Newfoundland and Labrador's recovery is delayed by work winding down on several major resource projects.

Alongside the expected growth in non-energy exports through 2018, underpinned by consumer products and machinery, the expansion of services is reflected in tech-related job creation in a number of mid-sized cities as well as the major CMAs. In tourism, a cross-Canada surge is spurring investment in new facilities and broader marketing. The federal *Budget's* attention to agri-food, clean tech, advanced manufacturing, digital industries, clean resources and health/bio sciences adds to provincial support. Ottawa's strategy recognizes existing expertise, such as the artificial intelligence clusters in Montreal, Toronto-Waterloo and Edmonton. Shadowing each province's outlook is the risk of adverse US tax and trade policy, with forest products a potential area of near-term vulnerability.

CONTACTS

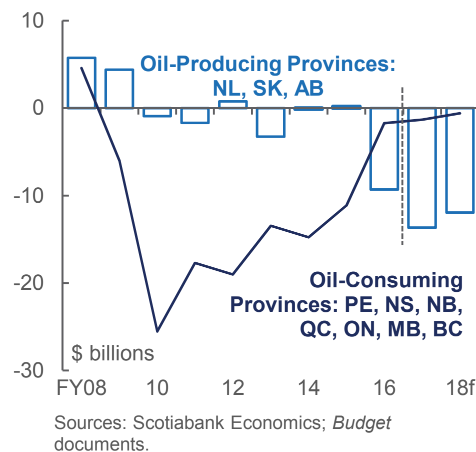
Mary Webb
416.866.4202
Scotiabank Economics
mary.webb@scotiabank.com

Chart 1



Sources: Scotiabank Economics, Statistics Canada.

Chart 2



Sources: Scotiabank Economics; *Budget* documents.

THE FISCAL OUTLOOK

With half of the provincial *Budgets* tabled for fiscal 2017–18 (FY18) by March 31st, balanced books or better are expected from five Provinces. The combined deficit of the three major oil-producing Provinces likely peaked in FY17 at about $13½ billion and is now expected to narrow (chart 2). While operating expenditures will continue to be carefully managed by all Provinces, for the four jurisdictions pursuing significant austerity in FY18, revenue and spending measures reflect concerns over competitiveness and job creation, as well as the bottom line.

Increasingly over the next few years, the challenge will be trimming consolidated provincial net debt burdens, relative to GDP and provincial receipts, while accommodating infrastructure outlays and the operating/maintenance expense for the new capital. Federal priorities, such as mental health care and home care, are adjusting provincial spending plans. Ottawa's review and retooling of its innovation programs will require similar provincial reassessments. Looking to rising interest rates, the Provinces have extended the term of their post-recession borrowings and several jurisdictions enter FY18 with considerable pre-financing.

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

Real GDP	CA	NL	PE	NS	NB	QC	ON	MB	SK	AB	BC
2000–15	2.2	2.5	1.8	1.4	1.2	1.7	2.0	2.4	2.1	3.1	2.7
2016e	1.4	-0.3	1.3	1.2	0.5	1.9	2.7	2.1	-0.4	-2.7	3.1
2017f	2.3	-1.7	1.4	1.4	0.7	1.9	2.5	2.3	1.7	2.4	2.4
2018f	2.0	-0.2	1.3	1.2	0.6	1.6	2.2	1.9	1.9	2.4	2.3
Nominal GDP											
2000–15	4.4	5.7	4.3	3.3	3.3	3.6	3.8	4.5	6.0	6.5	4.5
2016e	2.0	-1.9	2.4	2.4	1.5	3.1	4.2	3.3	-3.0	-4.9	4.8
2017f	4.7	1.8	2.9	3.1	2.3	3.7	4.8	4.4	5.1	6.0	4.5
2018f	4.0	3.0	2.8	2.8	2.2	3.4	4.0	3.7	4.4	5.3	4.1
Employment											
2000–15	1.4	1.0	1.2	0.7	0.5	1.3	1.3	1.0	1.3	2.5	1.2
2016	0.7	-1.5	-2.3	-0.4	-0.1	0.9	1.1	-0.4	-0.9	-1.6	3.2
2017f	1.3	-1.9	0.5	0.3	0.2	1.3	1.5	0.8	0.3	0.6	1.7
2018f	0.8	-1.2	0.3	0.3	0.2	0.7	1.1	0.6	0.5	0.8	1.1
Unemployment Rate (%)											
2000–15	7.1	14.3	11.2	8.9	9.6	8.1	7.2	5.1	4.9	4.9	6.6
2016	7.0	13.4	10.7	8.3	9.5	7.1	6.5	6.1	6.3	8.1	6.0
2017f	6.7	13.9	10.2	8.0	9.2	6.4	6.2	6.0	6.2	8.3	5.7
2018f	6.6	14.3	10.1	7.8	9.1	6.3	6.1	5.9	6.1	8.1	5.6
Housing Starts (units, 000s)											
2000–15	199	2.7	0.8	4.3	3.6	44	71	5.1	5.2	35	28
2016	198	1.4	0.6	3.8	1.8	39	75	5.3	4.8	25	42
2017f	195	1.4	0.5	3.6	1.9	41	78	5.8	4.5	25	34
2018f	185	1.3	0.5	3.7	1.8	39	72	5.5	4.6	25	32
Motor Vehicle Sales (units, 000s)											
2000–15	1,639	28	6	48	37	410	624	47	45	216	178
2016	1,949	33	9	54	44	458	807	55	51	220	218
2017f	1,940	31	8	54	42	456	800	56	52	223	218
2018f	1,925	30	7	54	41	452	792	55	53	226	215
Budget Balances, Fiscal Year Ending March 31 (CAD mn)											
2000–15	-2,917	59	-39	-31	-146	-1,009	-5,215	-84	425	1,746	291
2016	-987	-2,207	-13	-11	-261	2,191	-3,514	-846	-675	-6,442	730
2017f*	-23,000	-1,584	-18	12	-231	250	-1,920	-872	-1,289	-10,806	1,458
2018f*	-28,500	n.a.	n.a.	n.a.	-192	0	n.a.	n.a.	-685	-10,344	295

* FY17f & FY18f: Provinces' estimates, SK FY15–FY18f excluding pension accrual adjustment; history: MB:FY04–FY15 and AB:FY05–FY15.

United States

- **The US economy remains in a sweet spot of accelerating growth, moderate price pressures, improving labour markets, robust consumer demand, increasing manufacturing orders, and rising investment.**
- **The major risks to the US outlook lie within: in the midst of a firming global environment, policy missteps by the US authorities represent the greatest threat to the continuation of the US recovery.**

STRONG MACRO FUNDAMENTALS TRUMP POLICY UNCERTAINTY

Recent data prints confirm the gathering strength in the US economy we detailed in the previous quarter's *Global Outlook*. Consequently, our projections of real GDP growth of 2.3% in 2017 and 2.4% in 2018 remain unchanged (table 1). Although financial markets are beginning to reflect concerns that the 'Trump bump' in equity prices has run ahead of likely policy action by the new administration, the underlying macroeconomic fundamentals of the US economy continue to improve and are receiving additional support, as previously anticipated, from firmer global demand for US goods and services. The US recovery is proving robust to policy volatility in Washington, DC and should remain intact unless tax reform proposals seriously underwhelm expectations or the Trump Administration initiates a massive disruption in international trade.

WORK HARD, CONSUME HARD

US consumer spending remains well-supported by robust job gains, solid income growth, and strong household balance sheets. Reflecting these sound fundamentals, consumer sentiment indices are around their highest levels since 2000. Consumption is expected to increase by 2.7% in 2017 (table 2) and contribute nearly two percentage points to the economy-wide 2.3% increase in GDP.

Monthly payroll increases have averaged almost 200,000 over the past year, led by the construction and service sectors. Hiring surveys signal continued brisk labour demand across most regions and industries in 2017; manufacturers report their strongest hiring plans since the 2008–09 recession. Nevertheless, with most indicators also showing that the US labour market is near full employment, we expect the pace of hiring to slow as the year progresses. The US unemployment rate is already at a decade-low of 4.7%, wage growth is starting to accelerate, labour-force participation rates are turning up, and the aggregate employment-to-population rate is at an eight-year high.

Household incomes should get a further boost from higher minimum wages: increases took effect in 19 states during January 2017; three other states have legislated increases for July 2017 and additional increases are scheduled during 2018–20. Households may also pull forward consumption in anticipation of personal income-tax cuts long-promised by then-candidate and now President Trump.

Faster US consumption growth in 2017 is also supported by stronger household balance sheets that have been shored up by rising home values and equity-

CONTACTS

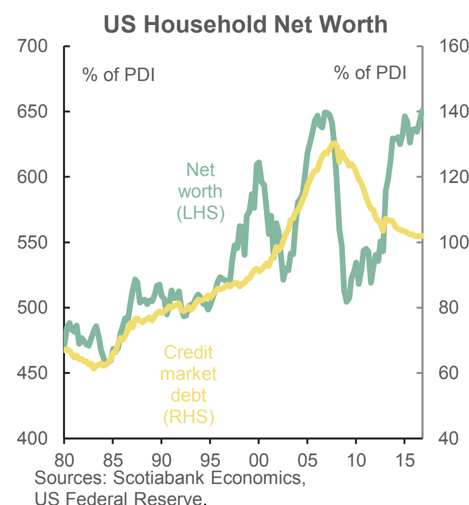
Brett House, VP & Deputy Chief Economist
416.863.7463
Scotiabank Economics
brett.house@scotiabank.com

Carlos Gomes
416.866.4735
Scotiabank Economics
carlos.gomes@scotiabank.com

Adrienne Warren
416.866.4315
Scotiabank Economics
adrienne.warren@scotiabank.com

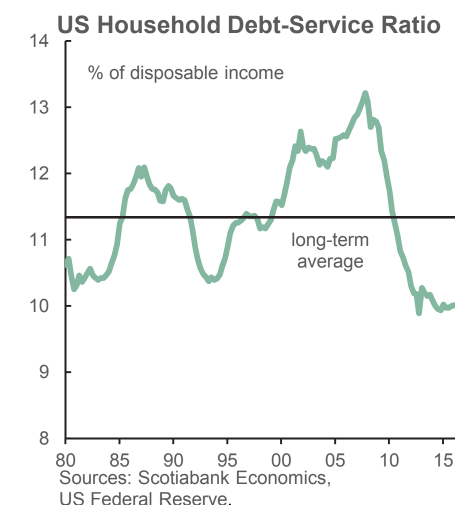
Mary Webb
416.866.4202
Scotiabank Economics
mary.webb@scotiabank.com

Chart 1



Sources: Scotiabank Economics, US Federal Reserve.

Chart 2



Sources: Scotiabank Economics, US Federal Reserve.

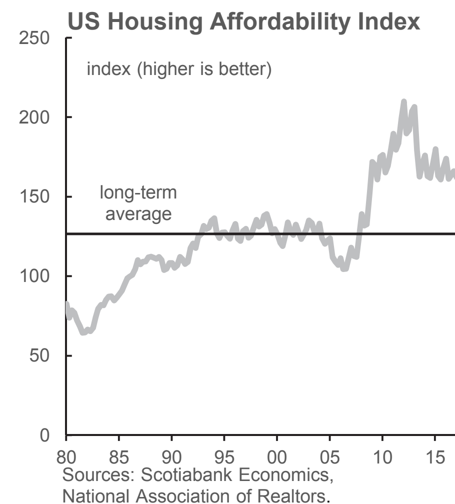
market gains. The US consumer's balance sheet should be able to support solid spending growth even as the Fed moves to raise the Fed funds target rate and increase consumer borrowing costs. Household net worth relative to disposable income is at a record high near 650%, while household credit-market debt as a share of disposable income is at an eight-year low (chart 1). At 10% of after-tax income, debt-service payments pose the weakest burden to consumers since at least 1980 (chart 2).

Strong household balance sheets should also support continued growth in residential investment, with knock-on demand for large-ticket consumer durables such as furniture, appliances, and electronics. The auto sector will also benefit from a combination of solid household finances and increasing demand to replace ageing vehicles: some 40% of the US vehicle fleet is as least 12 years old, owing to an extended period of weak vehicle purchases in the years following the global financial crisis. With interest rates still low and plentiful options for attractive financing, US vehicle sales are expected to hit a third consecutive annual record in 2017. The recent rise in delinquencies among subprime auto leases is unlikely to dampen overall

Chart 3

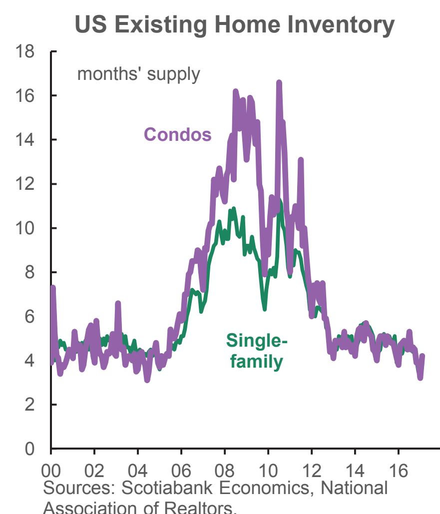
Sources: Scotiabank Economics, US Census Bureau.

Chart 4



Sources: Scotiabank Economics, National Association of Realtors.

Chart 5



Sources: Scotiabank Economics, National Association of Realtors.

Chart 6

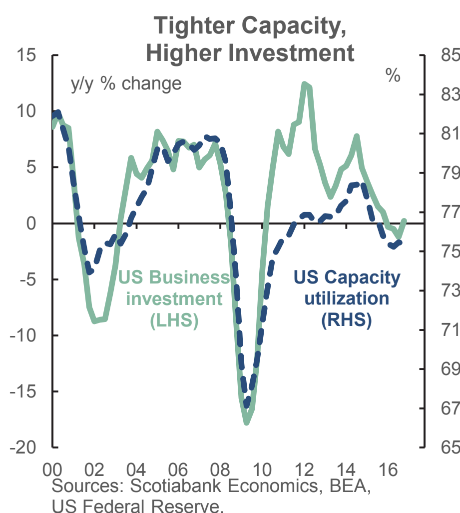
Sources: Scotiabank Economics, Federal Reserve Board, US Census Bureau.

Table 1 — Quarterly US Forecasts

	2016				2017				2018			
	Q1	Q2	Q3	Q4	Q1e	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Economic												
Real GDP (q/q ann. % change)	0.8	1.4	3.5	2.1	1.6	2.5	2.5	2.4	2.4	2.4	2.3	2.3
Real GDP (y/y % change)	1.6	1.3	1.7	2.0	2.2	2.4	2.2	2.3	2.5	2.4	2.4	2.3
Consumer Prices (y/y % change)	1.1	1.1	1.0	1.8	2.6	2.6	2.6	2.4	2.4	2.4	2.4	2.3
Core CPI (y/y % change)	2.2	2.2	2.2	2.2	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3
Financial												
Euro (EURUSD)	1.14	1.11	1.12	1.05	1.07	1.02	1.05	1.10	1.12	1.12	1.15	1.15
U.K. Pound (GBPUSD)	1.44	1.33	1.30	1.23	1.26	1.20	1.25	1.25	1.30	1.30	1.35	1.35
Japanes Yen (USDJPY)	113	103	101	117	111	115	117	117	121	121	122	122
Fed Funds Rate (upper bound, %)	0.50	0.50	0.50	0.75	1.00	1.25	1.25	1.50	1.50	1.75	1.75	2.00
3-month T-bill (%)	0.20	0.26	0.27	0.50	0.75	1.00	1.05	1.25	1.30	1.55	1.60	1.80
2-year Treasury (%)	0.72	0.58	0.76	1.19	1.25	1.40	1.50	1.70	1.75	1.90	1.95	2.10
5-year Treasury (%)	1.20	1.00	1.15	1.93	1.92	2.05	2.20	2.30	2.40	2.50	2.55	2.60
10-year Treasury (%)	1.77	1.47	1.59	2.44	2.39	2.55	2.70	2.80	2.85	2.90	2.95	3.00
30-year Treasury (%)	2.61	2.28	2.31	3.07	3.01	3.05	3.20	3.30	3.35	3.40	3.45	3.50

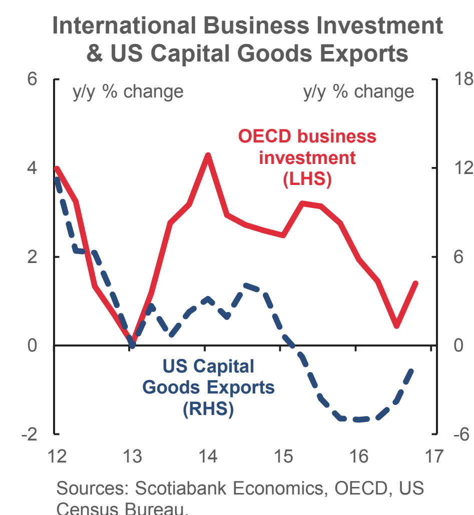
vehicle demand as the subprime share of overall purchases has been declining during the past two years.

Chart 7



Sources: Scotiabank Economics, BEA, US Federal Reserve.

Chart 8



Sources: Scotiabank Economics, OECD, US Census Bureau.

HOUSING: THE AMERICAN DREAM ROLLS ONWARD

Solid job and income gains, rising consumer confidence, and ageing millennials should sustain the existing forward momentum in US housing activity into 2018. Increased participation by first-time buyers has helped to lift US home sales to their highest levels in a decade. Purchases by non-occupying investors remain elevated, a reflection of the ongoing strength in rental demand and historically low vacancy rates (chart 3).

The pace of housing sales growth is nonetheless expected to slow during 2017. Affordability remains good from a historical perspective, but has begun to weaken alongside rising home prices and higher mortgage rates (chart 4). A persistent shortage of listings, especially for lower-priced homes, is also restraining activity. The inventory of existing homes for sale stands at just 1.75 mn, equivalent to 3.8 months' supply—near all-time lows (chart 5).

US housing starts are forecast to increase to 1.26 mn units in 2017 and 1.34 mn in 2018, with builder confidence in the market emboldened by tight resale inventory, rising home prices, and the potential for regulatory reform under the Trump Administration. The overall level of construction should remain below the historical average of around 1.5–1.6 mn units, reflecting labour shortages as well as rising land and construction costs.

MANUFACTURING ACCELERATES

US industrial activity continues to gain momentum alongside stronger domestic and international demand. New orders for goods manufactured in the United States are now advancing at the fastest annualized pace since mid-2014 and will continue to drive industrial activity higher (chart 6). In fact, US manufacturing output has increased for five consecutive months through February 2017, the best run in nearly three years. Consumer goods are leading the way, with orders and output climbing at a nearly double-digit year-over-year pace for the first time since 2011. These products account for more than 40% of overall US manufacturing activity. Demand for them should continue to receive support from the strengthening consumer fundamentals outlined above, solid payroll expansion, and the fastest wage gains in nearly a decade.

INVESTMENT SPENDING TURNS POSITIVE

Inventory restocking, record North American vehicle production, and rising demand foreign demand for US goods should buoy a nascent turnaround in investment spending during the months ahead. Orders for non-

Table 2 — United States

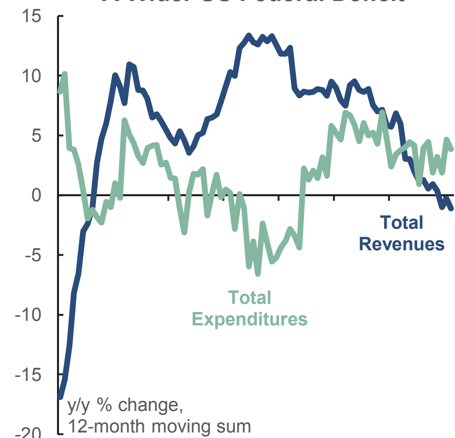
	2000–15	2016	2017f	2018f
	(annual % change, unless noted)			
Real GDP	1.9	1.6	2.3	2.4
Consumer Spending	2.3	2.7	2.7	2.7
Residential Investment	-0.7	4.9	3.8	2.7
Business Investment	2.4	-0.5	2.6	3.3
Government	1.0	0.8	0.9	1.1
Exports	3.8	0.4	2.3	2.8
Imports	3.5	1.1	4.4	3.5
Nominal GDP	4.0	3.0	4.3	4.4
GDP Deflator	2.0	1.3	2.0	2.0
Consumer Price Index	2.2	1.3	2.4	2.4
Core CPI	2.0	2.2	2.3	2.3
Pre-Tax Corporate Profits	5.9	-0.1	6.5	3.5
Employment	0.6	1.8	1.5	1.3
Unemployment Rate (%)	6.3	4.9	4.6	4.5
Current Account Balance (USD bn)	-521	-481	-472	-503
Merchandise Trade Balance (USD bn)	-668	-750	-820	-874
Federal Budget Balance (USD bn)	-529	-587	-610	-650
percent of GDP	-3.8	-3.2	-3.2	-3.2
Housing Starts (mn)	1.27	1.18	1.26	1.34
Motor Vehicle Sales (mn)	15.4	17.5	17.8	17.9
Industrial Production	0.8	-1.0	1.7	2.0
WTI Oil (USD/bbl)	64	43	53	56
Nymex Natural Gas (USD/mmbtu)	5.09	2.55	3.10	3.05

defense capital goods turned positive in the final months of 2016 alongside stabilization in capital spending in the oil and gas sector, after a peak-to-trough plunge of nearly 70% from 2014 through mid-2016. The oil and gas industry normally accounts for 8% of overall spending on machinery, but, since last spring, the sector has accounted for nearly a third of the increase in US machinery orders. Demand for machinery has also bottomed-out across other sectors, but the subsequent improvement has been muted and awaits a further recovery in profits and capacity utilization to gain more traction (chart 7).

Chart 9

Sources: Scotiabank Economics, US Census Bureau.

Chart 10



Sources: Scotiabank Economics, US Treasury.

While manufacturing operating rates have increased by nearly a percentage point since August, the overall capacity utilization rate hasn't recovered, as warmer-than-normal winter conditions have led to an 11% plunge in utilities output since December—the largest fall-off on record in data dating back to 1972. Utilities account for 5% of overall US re-investment spending and weak electricity demand could dampen the emerging upturn in overall investment spending.

MANUFACTURED EXPORTS GAIN MOMENTUM

While domestic purchases are the main driver of US manufacturing activity, strengthening global investment demand has also started to provide a boost to orders for US capital goods (chart 8). US exports of manufactured goods are now expanding in excess of 4% y/y, their best performance in four years (chart 9). While transportation equipment and information technology are the major US manufactured exports, international demand for US machinery has also turned positive in recent months and will provide a further kick to industrial activity as the sector has one of the highest export intensities amongst US industries: more than 35% of all machinery manufactured in the United States is destined for export, significantly above the 20% average for other industrial sectors. The pickup in global demand for US-made machinery and other capital goods points to a possible upturn in investment spending around the world. Investment has been one of the weak links in the global economic expansion in recent years, with overall capital expenditures growth slowing to only an annualized 2% since late 2014, 30% lower than the growth rate in the prior two years.

GOVERNMENT SPENDING AT BEST A MODEST POSITIVE

A moderate widening of the US federal deficit from 3.1% of GDP in calendar 2016 (chart 10) toward about 3.25% of GDP in 2018 is our base case. The expanding budget gap in part reflects some modest net federal tax relief projected for fiscal 2018. Total government activities, on both the current and capital sides, are likely to contribute a modest 0.1 percentage point to real GDP growth in calendar 2017 before increasing toward 0.2 percentage points in 2018.

We expect that the Trump Administration will match a large portion of its security and public-safety expenditure increases by limiting spending across a range of non-defence agencies and departmental programmes that are, individually, relatively small. In addition, state government expenditures are likely to become more circumspect given elevated uncertainty regarding future federal changes to healthcare and other social programmes. The healthcare impasse reinforces our expectation of significant delays in the Trump Administration's major initiatives, including the promised USD 1 tn 10-year infrastructure boost. The time needed to pass appropriations legislation, amend the sequester, and ratify a debt ceiling increase is expected to frustrate tax-reform efforts and delay more substantial federal outlays in the near term. Longer-term, pushing Social Security and Medicare issues down the road signals wider budget shortfalls in the years ahead and continuing acrimony over the debt limit.

RISKS TO THE UNITED STATES LIE MAINLY INSIDE THE BELTWAY

With the ongoing, broadly based improvement in US fundamentals, combined with a further acceleration in growth in other major advanced and emerging economies, the US outlook faces few straightforward economic downside risks at home or from abroad. Instead, the threats to the US are rooted mainly in the intersection between policy and politics.

The most present danger is that US federal tax reform and public-infrastructure plans will underwhelm market expectations. Equity markets have until recently priced a corporate tax cut in line with President Trump's comments from 35% to around 20% for the top bracket and the articulation this year of a USD 1 tn infrastructure spending package. A lesser tax cut and/or more extensive delays in moving ahead on public infrastructure spending could prompt firms to put some capital expenditure plans back on the shelf and cause significant repricing of equity risk. Our growth projections do not incorporate substantial tax relief, an outsized pick-up in business investment, or massive public infrastructure spending, but a large correction in equity markets, and its associated knock-on effects on household wealth and consumer confidence, would likely feed back into the real economy and threaten our outlook.

On trade, the Trump Administration's actions have so far inclined toward a less protectionist stance than campaign rhetoric indicated, but this could easily change as the uneasy balance between free-traders and mercantilists in the Administration continues to shift. Although the new President scored an own-goal by pulling the US out of the Trans-Pacific Partnership (TPP), the White House now says the TPP will serve as a "starting point" for future bilateral deals. On NAFTA, a draft negotiating memo indicates that only modest changes will be sought. But on China, President Trump is pursuing an aggressive line that US trade deficits with China remain unacceptable, without indicating what his government may do to address them. Self-defeating tariffs, quotas, and other trade barriers remain a possibility that could derail the US expansion and threaten global growth by touching off a trade war.

Geopolitical developments outside the US—from a possible confrontation with North Korea to ongoing tensions with Russia, turmoil in Europe surrounding Brexit, and national elections on the continent—could also dent risk appetite and place a brake on both the US and global recovery.

US & Canadian Monetary Policy & Capital Markets

BANK OF CANADA OUTLOOK — BET AGAINST RATE HIKES, FOR NOW

No change in policy rates is expected this year, with a first move expected in mid-2018. In our view, markets are prematurely pricing roughly one-in-four odds of a hike before the end of this year. Governor Poloz has made it clear that he is in no hurry to raise rates, and we believe he would be more comfortable with a temporary overshoot of the inflation target than an undershoot. If GDP growth continues at the recent pace then all else equal it may support a neutral-hawkish bias shift, but that's hardly clear and there are many other considerations.

Arguments in favour of a prolonged pause appear to carry the day at the Bank of Canada and fall into two broad categories.

Counter-arguments to hike logic

- While headline inflation is on target, gasoline price base effects are playing a major role and core inflation continues to trend lower (chart 1).
- Annualized job growth since July would roughly match the all-time record for job growth set in 1979 and is unlikely to be sustainable at this pace at the expense of labour productivity. Weakness in hours worked is an offset to job creation. Weak nominal wage growth at 1% y/y and falling real wages indicate appreciable labour market slack.
- Recent strength in retail sales may be driven by transitory factors such as elevated job growth and adjusting to higher child benefit payments.
- Q4 GDP growth was solid but masked weak investment and exports and was buoyed by import distortions. January GDP was solid but durability is unclear especially given that net exports are shaping up to be a big drag on Q1 GDP.
- Oil prices have stalled out and at best stabilize the energy cap-ex picture.
- Monetary policy is a blunt instrument not well designed to address housing markets in general, let alone regional housing markets. Toronto's pace of price gains may not be sustainable at the current pace.
- Sharp policy deviations between the US and Canada are not unprecedented (chart 2) and are presently supported by more disinflationary spare capacity in Canada than in the US (chart 3). The BoC sees inflation from currency weakness as transitory. A limit to this was tested as USDCAD hit 1.40–1.45.

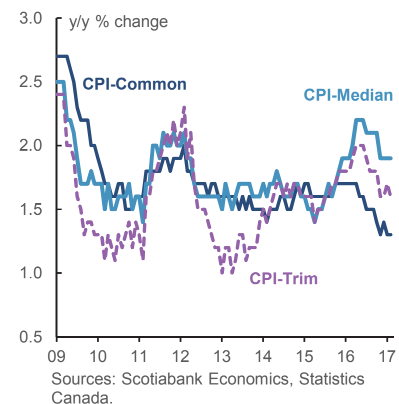
Additional considerations

- The BoC has long hoped for a rotation of the sources of growth away from reliance upon a mature household sector toward investment and exports.
- Equipment investment plunged by over 10% in each of the past two quarters. Investment intentions are solid, but a hoped for recovery would also raise productive capacity in disinflationary fashion.

CONTACTS

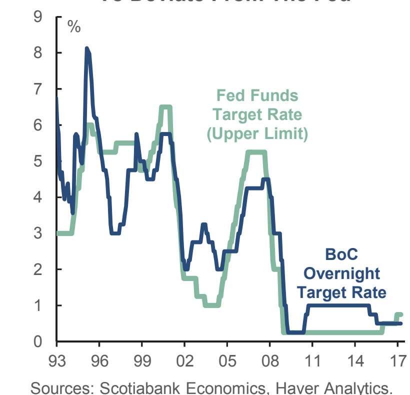
Derek Holt, VP & Head of Capital Markets Economics
416.863.7707
Scotiabank Economics
derek.holt@scotiabank.com

Chart 1



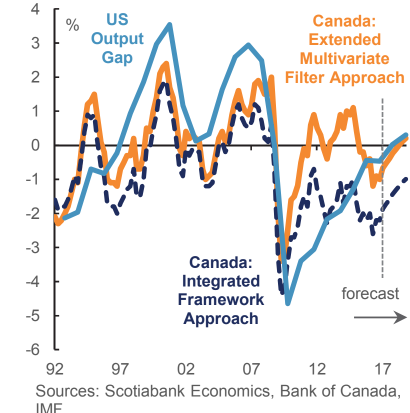
Sources: Scotiabank Economics, Statistics Canada.

Chart 2



Sources: Scotiabank Economics, Haver Analytics.

Chart 3



Sources: Scotiabank Economics, Bank of Canada, IMF.

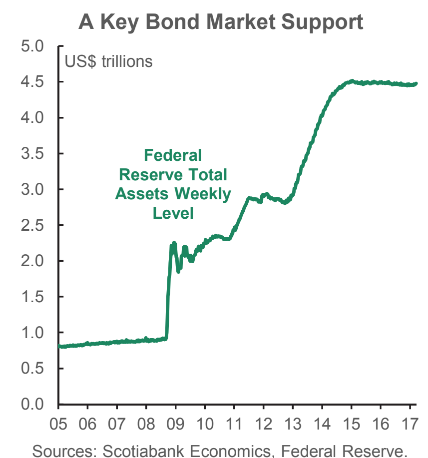
- The trend in export volume growth remains weak.
- US trade policy risks include 'tweaks' to NAFTA, an across-the-board US border tax, or the indirect effects of a more narrowly applied border tax that exempts Canada. The BoC is likely to remain cautious for at least as long as this issue clouds the outlook.
- As a temporary growth support, fiscal stimulus offers only subtle effects.
- Canada has imported a bond shock that may be unsuited to local conditions.

Arguments in favour of a rate cut would require a sharp shock to presently understood drivers of the framework. Recall Poloz's remark late last year when in response to a question about cut risk, he stated "It would require for us to have a significant departure in that outlook, such as we had in the case in the oil price shock." What we know about the base case outlook at this point downplays cut risk especially in the context of the risks to potentially courting negative rates.

FEDERAL RESERVE OUTLOOK — 2017 IS PRICED, FULLER CYCLE RISKS

Our base case outlook for the Federal Reserve continues to include:

- Three rate hikes in total this year which implies two more to come following the hike in March, likely in June and December as the pursuit of tax reforms is monitored over the summer. This is to be followed by two hikes next year that would bring the fed funds target rate to 2% by the end of next year. At present, roughly 1½ further hikes are priced into fed fund futures by the end of 2017.
- Continued reinvestment of maturing Treasury, agency and MBS holdings that would preserve the level of the Fed's balance sheet at about $4½ trillion as a bond market support throughout 2017–18 (chart 4). We assume a gradual reduction to reinvestment of maturing holdings when rate normalization is "well underway" which we define to be around a fed funds target rate of 2% or higher that is forecast to arrive into 2019.
- Our forecast for the terminal rate, or neutral rate is 3% in nominal terms, 1% in inflation-adjusted terms. This is the equilibrium rate that achieves stability in the Fed's dual mandate of full employment and price stability and is sometimes referred to as r-star.

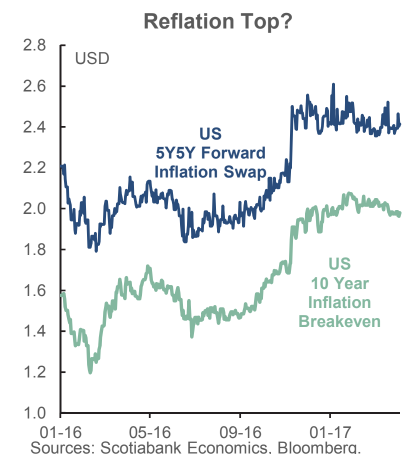


Sources: Scotiabank Economics, Federal Reserve.

The rationale for this base case forecast is rooted in sustained 2–2½% GDP growth throughout our forecast horizon that would slightly exceed the economy's estimated speed limit that the Fed puts at 1.8%. The result would be a closed output gap into 2018 and thus the complete removal of disinflationary slack. This is viewed as adequate to sustainably achieve the Fed's Congressionally mandated goals of price stability around a 2% inflation target and full employment around the Fed's estimate of a 4.7% unemployment rate. A degree of market stability is assumed that is highly contingent upon several risks.

Bi-directional sources of risk to this forecast include but are not limited to the following:

1. The Reflation trade: Markets and our forecasts assume that US inflation will persistently run at about 2% backed by commodities, wage growth and higher core inflation. A downside risk would be if core inflation pressures do not continue to fan out while energy-led base effects dissipate. An upside risk to inflation could come from stronger-than-forecast domestic and global growth that puts the US economy into excess demand conditions and raises inflation risk. A protectionist border tax could also accelerate inflation temporarily but likely drive disinflationary forces thereafter and how the Fed reads this will be important.



Sources: Scotiabank Economics, Bloomberg.

2. Other domestic policy risks: We remain sceptical of the potential benefits to growth from a possible shift in US fiscal, regulatory and trade policies as this first piece outlined. The benefits to the economy and markets relative to what is priced may very well remain exaggerated even if governance were to improve.

3. Geopolitical risks remain high including but not limited to European elections and foreign policy challenges in Asia.

4. Animal spirits: Will strong consumer confidence portend an acceleration in consumer spending with positive implications for top-line revenues that support present equity valuations? The evidence suggests the opposite risk in that consumer confidence usually peaks very late in the cycle after most gains have become exhausted (chart 6). Furthermore, there is no growth in consumption being tracked in Q1 this year.

5. The USD: Having fallen back to about where it was at the time of the US election, dollar strength poses slightly less downside risk to net exports and inflation but our house view sees further appreciation in the near-term.

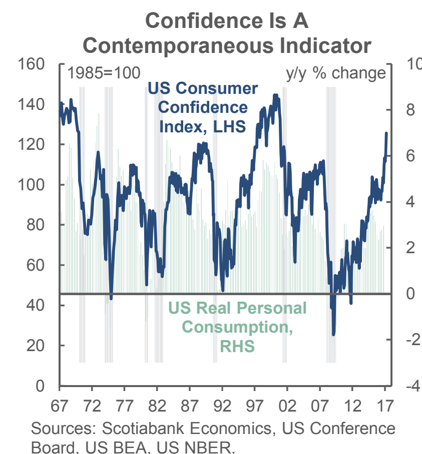
6. Vacancies remain a key source of uncertainty regarding the bias of the future composition of the Federal Open Market Committee and mainly next year. Since this piece surveyed the scope of potential vacancies, only one has been filled; retired Atlanta Fed President Dennis Lockhart has been succeeded by Raphael Bostic.

BOND MARKETS — BEAR FLATTENERS, BUT DON'T ABANDON ALL BONDS

Our base case forecast for rising bond yields is somewhat more focused upon shorter-term maturities than longer-dated securities. Please see the accompanying table below for forecasts and chart 7 for a depiction of the bear flatteners that we continue to stand by.

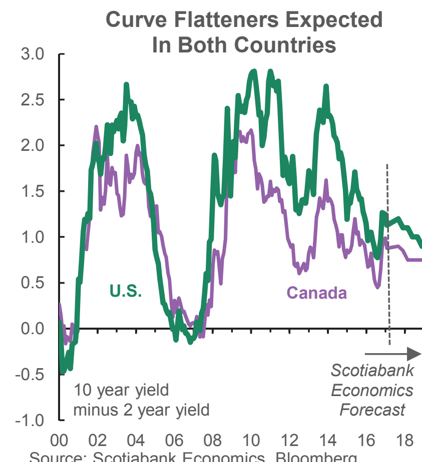
One reason for forecasting faster increases in shorter-term rates than longer-term yields is keyed off of US monetary policy expectations. A considerable part of our base line forecast for the Federal Reserve is priced into shorter-dated Treasuries. At present, fed

Chart 6



Sources: Scotiabank Economics, US Conference Board, US BEA, US NBER.

Chart 7



Source: Scotiabank Economics, Bloomberg.

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

	2016				2017 (end of quarter, %)				2018			
Canada	**Q1**	**Q2**	**Q3**	**Q4**	**Q1**	**Q2f**	**Q3f**	**Q4f**	**Q1f**	**Q2f**	**Q3f**	**Q4f**
BoC Overnight Target Rate	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.75	0.75	1.00
Prime Rate	2.70	2.70	2.70	2.70	2.70	2.70	2.70	2.70	2.70	2.95	2.95	3.20
3-month T-bill	0.45	0.49	0.53	0.46	0.55	0.50	0.50	0.50	0.60	0.80	0.90	1.10
2-year Canada	0.54	0.52	0.52	0.75	0.75	0.85	0.95	1.05	1.20	1.35	1.45	1.60
5-year Canada	0.68	0.57	0.62	1.11	1.12	1.25	1.35	1.40	1.50	1.65	1.80	1.90
10-year Canada	1.23	1.06	1.00	1.72	1.63	1.75	1.85	1.90	1.95	2.10	2.20	2.35
30-year Canada	2.00	1.72	1.66	2.31	2.30	2.35	2.45	2.50	2.55	2.65	2.75	2.80
United States	**Q1**	**Q2**	**Q3**	**Q4**	**Q1**	**Q2f**	**Q3f**	**Q4f**	**Q1f**	**Q2f**	**Q3f**	**Q4f**
Fed Funds Target Rate	0.50	0.50	0.50	0.75	1.00	1.25	1.25	1.50	1.50	1.75	1.75	2.00
Prime Rate	3.50	3.50	3.50	3.75	4.00	4.25	4.25	4.50	4.50	4.75	4.75	5.00
3-month T-bill	0.20	0.26	0.27	0.50	0.75	1.00	1.05	1.25	1.30	1.55	1.60	1.80
2-year Treasury	0.72	0.58	0.76	1.19	1.25	1.40	1.50	1.70	1.75	1.90	1.95	2.10
5-year Treasury	1.20	1.00	1.15	1.93	1.92	2.05	2.20	2.30	2.40	2.50	2.55	2.60
10-year Treasury	1.77	1.47	1.59	2.44	2.39	2.55	2.70	2.80	2.85	2.90	2.95	3.00
30-year Treasury	2.61	2.28	2.31	3.07	3.01	3.05	3.20	3.30	3.35	3.40	3.45	3.50

fund futures are pricing about three of our forecast five hikes by the end of 2018. This implies some further room for upward pressure on shorter-dated securities.

A second reason is our view on the term premium in Treasuries (chart 8). Recall this measure compares 10 year zero-coupon Treasury yields to a series of short-term maturity bonds. It had been rising in the wake of the election and a little before that when global turmoil over 2016H1 began to subside. Investors began to build in rising inflation expectations and demanded more of a premium to lock in a nominal bond for a finite longer term. More recently, this term premium is hovering around zero as reflation enthusiasm has peaked. For our forecast purposes, we assume that an average term premium around zero will be maintained as a compromise between not returning to last year's distortions and restraining enthusiasm for the so-called reflation and Trump trades.

Foreign 'carry' trades into US Treasuries will also likely continue to cap Treasury yields. The nominal yield spread between, say, US 10 year yields and 10 year bunds sits at over 200bps and versus 10 year JGBs it is over 230bps. Such a yield pick-up makes Treasuries relatively attractive to global fixed income portfolios and maintains demand.

Chart 8

Sources: Scotiabank Economics, Federal Reserve Bank of New York.

Overall, sovereign bonds will likely remain over-valued throughout our forecast horizon relative to a classic rule of thumb that relates 10 year nominal Treasury yields to longer-run expectations for nominal GDP growth that could be reasonably portrayed around 4% including 2% longer-run inflation. A major reason continues to be the relative scarcity of tradable fixed income product brought on by quantitative easing programs at major global central banks. This scarcity continues to worsen as bond buying programs continue at the ECB and Bank of Japan while the Fed continues to reinvest maturing Treasuries. The greater upside risk concerns supply pressures pending developments in US fiscal policy.

Mexico

HIGH SUSPENSE AND SHARP CONTRASTS

- **Heightened uncertainty about possible changes to US trade policy is curbing investment and weakening the outlook for economic growth.**
- **There are sharp contrasts among different sectors: some contracting dramatically (oil production, heavy construction) and some expanding rapidly (communications, financial services, some manufacturing).**
- **Inflation is rapidly rising due to the increased fuel prices implemented by the government.**
- **To manage inflationary expectations, Banco de Mexico is acting swiftly to increase interest rates.**

For an economy with real growth potential of 4% y/y, a forecast of 1.4% for the present year looks grim and even weak. The situation is not as grim as the headline growth number suggests, as there are sharp contrasts in economic activity among sectors and regions within Mexico. Some sectors are experiencing challenges and pulling GDP growth lower, but many other sectors and regions are thriving.

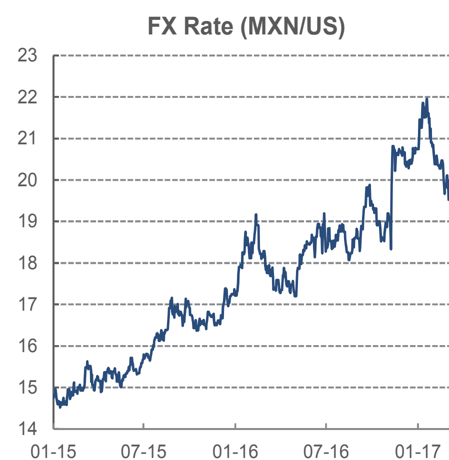
It has been a rough start of the year for the Mexican economy. The Mexican peso has been on a roller coaster ride, reacting mainly to comments made by the new administration in the US. First, comments made by President Trump on his inauguration speech sent the peso through the roof, reaching close to 22 MXN/USD and losing close to 6%. Then a more temperate and constructive set of comments by Wilbur Ross and Peter Navarro paved the way for a sharp strengthening of more than 14% on the Mexican peso, reaching levels below 19 MXN/USD (chart 1). This more positive climate in the market had led us to an improved forecast for the Mexican peso.

This wide volatility is a reflection of the heightened uncertainty generated by the possible changes in the trading policy of the United States. Much is at stake for the North American economy and for the many firms that have developed competitive advantages by building deep trade relationships and supply chains across the three countries. According to anecdotal information, the uncertainty surrounding US trade policy has led many firms to put new investment plans on hold, while ongoing investments continue. In addition, public spending on physical investment is contracting due to the fiscal consolidation. As a result, we are expecting a contraction in total investment during the current year. There are some already visible signs of this effect: the building component of the construction industry that had been previously growing at high rates, contracted 1.0% real y/y in January; and banking credit to the construction industry also contracted by 1.5% real y/y in the same month. Another concerning sign is the unprecedented drop in consumer confidence during January (lowest on record), and then the tepid recovery of February (second lowest on record), which could suggest a slowdown in the consumption rhythm.

CONTACTS

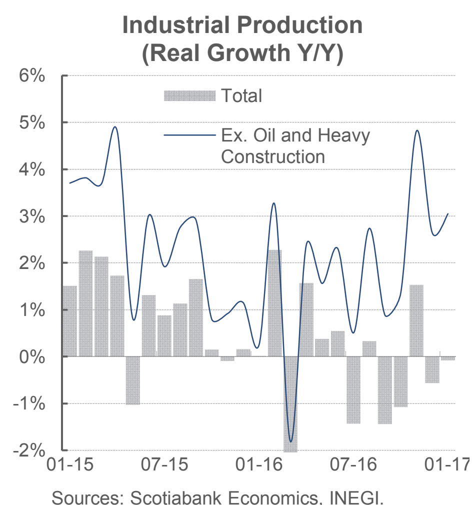
Mario Correa
52.55.5123.2683 (Mexico)
Scotiabank Mexico
mcorrea@scotiacb.com.mx

Chart 1



Sources: Scotiabank Economics, Banco de Mexico

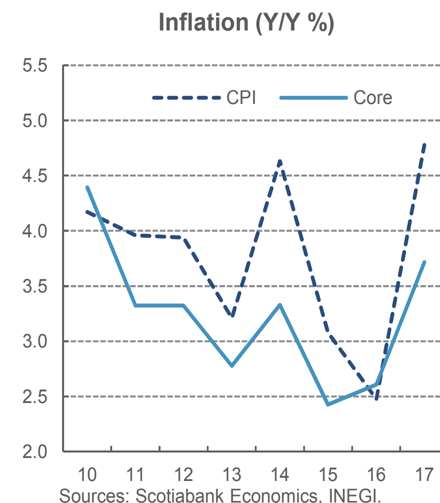
Chart 2



Sources: Scotiabank Economics, INEGI.

There are, however, sharp contrasts in the economy. Industrial activity, on the one hand, contracted 0.1% real y/y in January, but was heavily influenced by downturns in oil extraction (-11.9% real y/y) and heavy works construction (-11.1% real y/y). On the other hand, manufacturing activity grew 4.3% real y/y in January, with outstanding performance in sectors such as basic metal industries (+10.2% real y/y) and machinery and equipment (+12.1% real y/y). Excluding oil extraction and heavy construction from the total industry, the rest of industrial activities grew 3.1% real y/y, as can be seen in chart 2. Different indicators suggest a strong internal market: job creation was very positive in February (+154 k), retail sales grew 4.9% real y/y in January and automobile sales grew 6.5% real y/y in February.

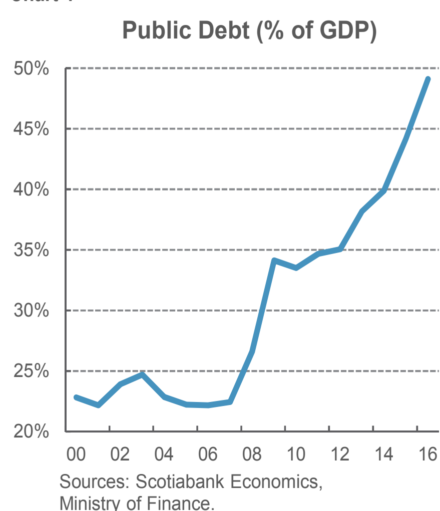
Chart 3



Sources: Scotiabank Economics, INEGI.

Inflation is on the rise and has reached levels not seen in the last seven years, with the Consumer Price Index reaching 5.29% y/y in the first half of March and the core component reaching 4.32% y/y (chart 3). This unusual rebound is mainly explained by the beginning of the liberalization process of fuel prices and the pass-through effect from the accumulated depreciation of the currency. Even though it is expected that this inflationary increase will be temporary, there is a serious risk of second order effects that could generate an undesirable inertia in inflation dynamics. To prevent this, Banco de Mexico has been acting on the monetary policy by rapidly increasing the reference interest rates, hiking 325 basis points since December 2015, and it is expected that it will continue tightening the monetary policy another 100 basis points during the rest of 2017.

Chart 4



Sources: Scotiabank Economics, Ministry of Finance.

Another matter of concern is the upward trend of public debt (chart 4). There have been many different warnings about the weakening of the fiscal discipline, from the International Monetary Fund and the international rating agencies to many private sector analysts. The federal government has taken different actions to reach the official deficit targets, which have been met. Much of the improvement in the budgetary situation is explained to a large degree by unusual revenues, such as the operational surplus of Banco de Mexico. Total public spending keeps growing as a percentage of GDP, and this could spell trouble in the future. More decisive action to curb the spending side of the fiscal policy appears to be required in order to strengthen the macroeconomic fundamentals of the country.

On this framework, we are anticipating for 2017 a significant slowdown of the total real GDP growth to 1.4%, mainly affected by a 2.6% contraction in total investment, while private consumption is expected to grow 1.9%. The Pemex reorganization is ongoing, leading to decreased oil production. Weaker construction activity is compounding this impact, leading to an expected contraction of 0.2% in industrial production. The services sector is expected to be less affected by the uncertainty and grow 2.4%. Total inflation is forecast to reach 5.9% while core inflation is expected to jump to 4.9%. The Mexican peso is expected to show high volatility during the year, ending close to 21.3 MXN/USD, but it is worth noting that there are many possible outcomes for the exchange rate.

In summary, 2017 appears to be a complicated year for the Mexican economy, which is expected to underperform. On the other hand, the medium- and long-term outlook for Mexico remains positive, and once all the headwinds affecting the immediate horizon start to dissipate, the economy should start gathering momentum and performance will improve.

United Kingdom

- **There are tentative signs that the UK economy is now cooling off.**
- **Sharply higher inflation is eroding household real income growth and has already caused retail sales growth to decelerate.**
- **We expect this theme to continue as inflation rises further.**
- **CPI inflation has accelerated to above the BoE's 2% target and we expect a further rise to above 3% in the autumn, before slowing back towards target over the subsequent 18 months.**
- **While speculation of a rate hike is likely to increase during H1, we do not expect the MPC to deliver a hike, particularly if growth slows as we forecast over the course of the year.**

GROWTH:

A stronger-than-expected end to 2016 has mechanically shifted our GDP growth forecast for 2017 growth upwards to 2.0% y/y. While that represents an acceleration compared with the 2016 annual average of 1.8% y/y, underneath the surface our forecast encapsulates a slowdown in growth. More specifically, we expect the % q/q growth rate to slow steadily throughout the year, down from 0.7% q/q at the end of 2016, to just 0.2% q/q by end-2017. Similarly, although we expect the quarterly growth rates to be on an upwards trajectory during 2018 (hitting 0.5% q/q by end-year) our annual average forecast for 2018 is a lowly 1.2% y/y. The point is that the annual average growth rates are something of an optical illusion.

In terms of the main drivers of growth; it is all about the consumer. More specifically, we expect sharply higher inflation to erode household real purchasing power, in turn causing consumer spending growth to decelerate. Retail sales growth has already slowed somewhat, alongside a sharp acceleration in its deflator. This confirms to us that this mechanism is working and GDP growth will slow this year. We had assumed that the worst news for the consumer would be centred on the second half of 2017, to coincide with inflation reaching its peak. However, the slide in retail sales growth in recent months highlights the risk of a more abrupt slowdown occurring sooner than our base case.

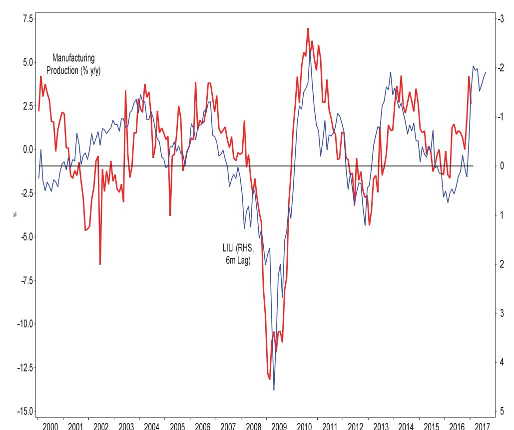
On a more positive note, the sectors of the economy that are sensitive to the exchange rate have seen an improvement in their fortunes. Manufacturing production growth has accelerated. Net trade has improved. Both are consistent with our Leading Indicator for Leading Indicators (LILI) model, which shows the most accommodative financial conditions for decades (chart 1). So while we doubt that these sectors will fully offset the downside from weaker consumer spending, they do represent a cushion that will prevent too much weakening in GDP growth.

CONTACTS

Alan Clarke, Head of European Fixed Income Strategy
44.207.826.5986 (London)
Fixed Income Strategy
alan.clarke@scotiabank.com

Chart 1

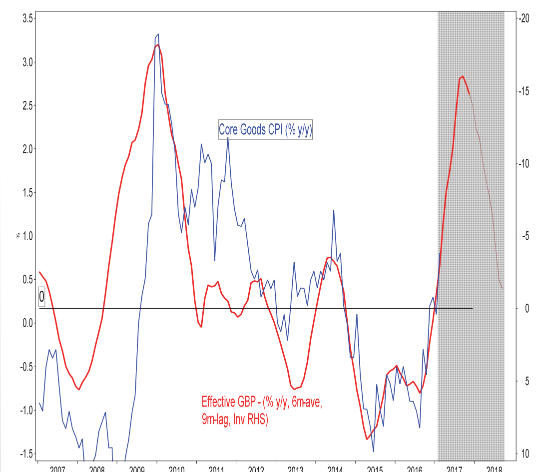
LILI Model vs Manufacturing Production Growth



Source: Macrobond.

Chart 2

Core Goods CPI vs Trade Weighted GBP Exchange Rate



Source: Macrobond.

INFLATION:

CPI inflation is now above the Bank of England's 2% inflation target for the first time since late-2013 and up from negative territory in late-2015. We expect further upside in the coming months, with headline inflation reaching a peak of 3¼% in the autumn. Thereafter, we expect inflation to return towards the Bank of England's 2% target over the subsequent 18-month period.

Recent CPI data have shown clear evidence of the effects of the weaker pound exerting upwards pressure on inflation. Chart 2 plots the core goods category of inflation (i.e., the most exchange rate-sensitive components of the CPI basket) against the trade weighted GBP exchange rate. This category of inflation has risen from -1% y/y to ¾% y/y and the chart suggests a further acceleration to a peak of 3% y/y. These components represent 30% of the weight in the CPI, which implies a further 0.7% addition to headline CPI inflation. On top of that, domestic energy bills, higher food price inflation, airfares, package holidays and taxes on alcohol and tobacco should all ensure that headline inflation rises to above the 3% upper boundary of the BoE's target range.

Unless the GBP exchange rate continues to weaken persistently, at some point the upwards pressure from imported inflation will begin to dissipate, helping headline inflation to gravitate back towards the 2% target during 2018–19.

Crucially, services sector inflation has remained muted in the past two years and we expect more of the same during 2017. In turn, a key reason for subdued services sector inflation is the lack of acceleration in wage growth. We expect wage inflation to move sideways during 2017, implying limited upside for services inflation.

MONETARY POLICY:

We stand by our view that the first half of the year will be hawkish, followed by a dove-friendly second half of the year. More specifically, with CPI inflation approaching 3% y/y, GDP growth robust for now and unemployment continuing to fall, the bias within the BoE has turned hawkish. One member has voted for a rate hike and other members of the committee have conceded that it would not take much more favourable data to push them into voting for a rate hike. However, we do not expect the Bank to deliver a rate hike this year. In particular, weaker GDP growth during the second half of the year (and the prospect of it) is likely to deter the committee from hiking.

The BoE has identified three key influences that will determine the future path of interest rates: wage inflation, consumption growth and inflation expectations. In terms of the specifics of these:

- We expect **wage inflation** to undershoot the BoE's end-year forecast of 3% y/y. This implies that domestically generated inflation is likely to remain muted and the committee can look through elevated headline inflation.

- Given the slump in retail sales we believe that household **consumption growth** is more likely to disappoint relative to expectations, rather than be more resilient than the Bank has forecast.

- **Inflation expectations** have followed headline inflation higher to stand at 2.9% y/y. In the past, a reading of 3¼–3½ has provoked dissents for a rate hike. We suspect that this "trigger level" will be reached in the next 3–6 months.

We expect the two dove-friendly influences to outweigh the rise in inflation expectations, ultimately resulting in unchanged monetary policy during 2017. Speculation of a rate hike is likely to return during 2018, particularly once the % q/q pace of GDP growth has accelerated to a more respectable level during H2. Furthermore, accelerating wage inflation should also make the case for a rate hike more likely in 2018, although ultimately we expect the BoE to wait until early 2019 before eventually delivering the first hike.

Eurozone

- **Signs of strengthening economic activity continue to build.**
- **Headline inflation is trending comfortably around policymakers' target, while core inflation appears set to finally start picking up.**
- **A more hawkish central bank could be in the pipeline.**

GROWTH IS STRENGTHENING AND BECOMING MORE BROAD-BASED

After a 0.4% q/q rise in the last quarter of 2016, the Eurozone economy has shown signs of a significant acceleration. In recent months, all business surveys have continuously surprised on the upside, pointing to GDP growth rising closer to 2.5% y/y, up from 1.7% y/y at the end of last year. This is significantly stronger than potential growth, estimated at around 1.1% y/y, indicating that the Eurozone output gap could be closing at a quicker pace than forecasted a few months ago.

Across the euro currency bloc, Germany will likely be an economic outperformer thanks to strengthening global demand (higher US ISM, Chinese PMI, etc.). Indeed, the latest IFO surveys have reached their highest levels since 2011 at which time German GDP growth was advancing by more than 4.0% y/y. However, there are also indications that the Eurozone recovery is broadening across its member states, with PMIs rising in France and Italy despite the adverse impact of heightened political uncertainty. Furthermore, highly supportive financial conditions continue to bolster the Eurozone recovery, with interest rates remaining at low levels alongside ongoing stimulus offered by the European Central Bank (ECB). The weaker euro is also providing a boost, with the nominal effective exchange rate trending at its lowest level in almost 15 years and aiding local competitiveness. Credit growth has thus strengthened, rising to 2.3% y/y in February, which is its strongest pace since 2009 and more than double the rate of growth seen a year ago. Taken together, these developments strengthen the view that the recovery in the Eurozone is becoming more sustainable.

As we suspected three months ago, the risk to the Eurozone growth outlook has now shifted to the upside, with both the EU Commission and the ECB revising their real GDP growth forecasts for this year and next year up closer to 2.0% y/y.

INFLATION HAS LIKELY REACHED ITS PEAK, BUT CORE INFLATION SHOULD START TO MOVE HIGHER

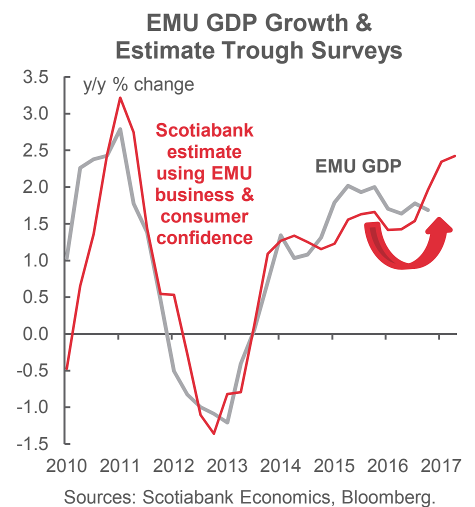
Eurozone headline HICP likely reached a temporary peak at 2.0% y/y in February. We expect consumer price inflation to soften to around 1.7–1.8% y/y over the coming months as a result of easing year-over-year gains in energy and food prices. In fact, base effects from these components could actually start to become negative, with gasoline prices moving down since the beginning of March and the rise in food prices in March/April of last year well above the 4-year average. Furthermore, while colder-than-usual temperatures in recent months have contributed to upside surprises in fresh food prices, this should be less of a factor going forward as weather conditions are improving. All in all,

CONTACTS

Frédéric Prêtet
33.1.703.77705 (Paris)
Fixed Income Strategy
frederic.pretet@scotiabank.com

Chart 1

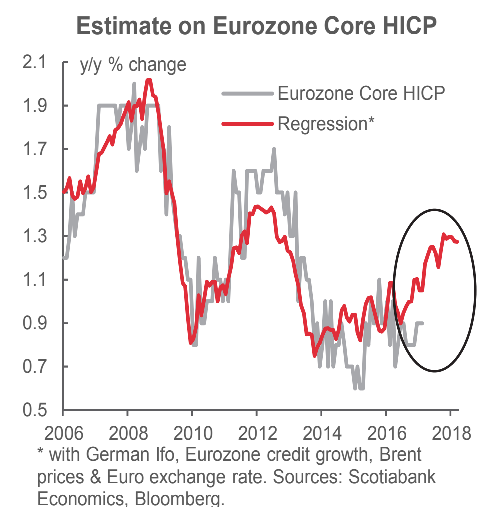
GDP Growth To Accelerate Significantly



Sources: Scotiabank Economics, Bloomberg.

Chart 2

Risk To Core Inflation Shift On The Upside



* with German Ifo, Eurozone credit growth, Brent prices & Euro exchange rate. Sources: Scotiabank Economics, Bloomberg.

assuming food prices increase in line with the traditional seasonality, the y/y trend should ease in the coming two to three months.

However, core inflation is expected to gradually pick up, moving above the 1.0% y/y line which is seen by the ECB as the "high deflationary risk area". The main drivers of the expected acceleration can be attributed to the following:

- The positive spill-over from higher energy prices has started to feed through to service prices, underpinned by rising transport prices. Indeed, growth in Eurozone transport prices has moved up from a low of 0.5% y/y one year ago to close to 2.0% y/y in February. In view of its past relationship with oil prices, this trend should continue over the coming months, with transport prices forecast to reach gains of 3.0% y/y or more, which in turn should continue to bode well for higher service prices.
- A reduction of the negative output gap alongside strengthening economic activity, higher credit growth, ongoing favourable financial conditions and a competitive euro exchange rate are all positive developments for core inflation. Indeed, a simple regression containing these factors shows that there are now more upside than downside risks to Eurozone core inflation.

IMPROVING FUNDMENTALS COULD SPUR A MORE COMPELLING DEBATE ON ECB TAPERING

The last ECB meeting showed that the tone inside the board is gradually shifting in the hawkish direction. In particular, the ECB president clearly indicated that no further monetary action is needed and there is growing optimism regarding the macroeconomic outlook. At this stage, the main arguments for keeping a cautious stance seems to be the lack of improvement in core inflation and the high level of political risk ahead of the upcoming French presidential and parliamentary elections in May and June. However, by the beginning of the summer, we expect both core inflation to have picked up and the uncertainty surrounding the French elections to have passed. If this is the case, we believe that the ECB could further adjust its tone to reflect the improving macroeconomic picture and that the debate surrounding tapering could become more prevalent at the ECB's June meeting.

Latin America Capital Flows

- **Robust capital flows; resilience to low growth; China/Mexico stress.**
- **Continuous rebalancing of investment portfolios; Southern Cone revival.**
- **Uneven monetary policy in Developing Americas; North-South divide.**
- **Currency stabilization; smooth alignment to commodity price shifts.**
- **Intensifying election-related uncertainty; leadership renewal in context.**

Emerging markets are in fashion once again. Growth and interest rate differentials remain a key magnet to global portfolio investors in search of higher-yielding Latin American assets in a world of excessively low interest rates. The ultra-stimulating monetary policies in credit-intensive advanced economies (such as the US, the UK and certain jurisdictions in Europe) continue to direct capital flows to core economies in the developing Americas. The persistence of global liquidity excesses is preventing a more rigorous approach to intra-regional credit risk differentiation in Latin America in a context of below-potential regional economic growth. The voluminous capital flight suffered by China, as measured in the sharp decline in central bank reserves (down US$1 trillion between July 2014 and January 2017) was taken with utmost indifference by dedicated emerging-market investors. Even the elevated financial market stress in Mexico as a result of the US presidential elections has been gradually unwound, proving incentives for opportunistic trading activity.

Global investors remain in active portfolio rebalancing of their exposure to emerging markets in general and to Latin American assets in particular. It is quite telling that exposure to China's corporate bond markets has been declining, triggered by fears of excess leverage in selected sectors of the economy (real estate in focus) at a time when the Chinese central bank lost a sizeable amount of international reserves. However, the core sovereign issuers in Latin America remain relatively immune to the escalating capital flight in China, which seems to be relatively well engineered by supply/demand market forces. Within the developing Americas, the return of Brazil and Argentina as core players in both primary and secondary debt markets accelerated a process of intra-regional rebalancing which alleviated investors' exposure to Mexico and increased holdings of Southern Cone credits in the hemisphere. Looking ahead, Latin America will have a more balanced presence in emerging markets at large despite the lingering risks affecting Mexico as a result of potential policy shifts in the USA.

Interest rate differentials remain a primary factor swaying capital flows to emerging markets. Policy shifts in the USA remain a factor of potential stress. Although the "Fed fear" factor has somewhat dissipated as there is better clarity of US policy developments, yield differentials between local government bonds and US treasury assets might increase in relevance in the coming months providing, at times, bouts of market volatility within the high-yield debt segments. The continuous development of local-currency government securities continues to

CONTACTS

Pablo Bréard, VP & Head of International Economics
416.862.3876
Scotiabank Economics
pablo.breard@scotiabank.com

Chart 1

Sources: Scotiabank Economics, JP Morgan.

Chart 2

Sources: Scotiabank Economics, JP Morgan.

direct portfolio flows to selected countries in the Western Hemisphere. Mexico, with large-scale participation of foreign portfolio investors, remains the pre-eminent core jurisdiction in Latin American debt markets. In this regard, monetary policy developments (and the ensuing inflation context) are critical to keep the interest rate premium as a key magnet of capital inflows. There is evidence of a divergent trend in monetary policy dynamics between the North (USA and Mexico) and the South (Brazil, Colombia and Chile). The stark contrast between rising central bank rates in Mexico—which helped stabilize Mexican currency market stress—and steady rate declines in Brazil is proof of this divide between Northern and Southern markets.

Latin American exchange rates have enjoyed a phase of steady consolidation over the past four months. Nevertheless, the regional currency environment might be subject to sporadic volatility swings through the remainder of the year, primarily influenced by the direction of the US dollar (USD) versus its peer major currencies and unforeseen shifts in US monetary policy. However, the complete unwinding of the sharp currency weakness suffered by the Mexican peso (MXN) following the completion of US presidential elections is indicative of the strong support of foreign portfolio investors as well as the country's highly attractive interest rate differentials. Bullish financial market sentiment to the Brazilian real (BRL) remains in place, despite the activation of an aggressive monetary easing cycle by the central bank. The normalization of copper price trends has stabilized trading activity in both the Peruvian sol (PEN) and Chilean peso (CLP), yet volatile changes in crude oil prices might keep the Colombian peso (COP) on the defensive in the months to come.

The Latin American region initiates a period of electoral intensity leading to leadership renewal in the core economies. The imminent election in the state of Mexico will provide a clear hint of electoral sentiment towards the current leadership and potential demands from society ahead of next year's presidential vote scheduled for July 2018. At times, US-Mexico bilateral relations might fuel volatile market-moving events. As for other members of the Pacific Alliance, presidential elections will take place in Chile (November 2017) whereas congressional and presidential elections are scheduled for March and May 2018 in Colombia. Other core economies within the region with scheduled elections include: Argentina's congressional elections (October 2017), Venezuela's presidential elections (April 2018) and Brazil's general elections (October 2018).

Brazil

- **Slow economic recovery in motion; active disinflation is under way.**
- **Improved global perception of Brazilian sovereign credit risk.**
- **The Brazilian real (BRL) remains the world's best performing currency.**
- **Deeper fiscal consolidation is critical to improve economic outlook.**
- **Leadership renewal in sight; elections scheduled for October 2018.**

Business confidence indicators show signs of improvement in the first two months of the year. The inflation and monetary outlook is also improving. Following two years of deep recession, the economy will post positive growth in 2017. We expect that real GDP will expand by 0.5% before accelerating to 2–2.5% in 2018. The ongoing correction of deep macroeconomic (fiscal and external) imbalances will facilitate a slow and gradual recovery. The economic legacy of the previous administration which led to the presidential impeachment last August included a 12% unemployment rate and a 7.4% contraction of real GDP over the past seven quarters.

The central bank has adopted a pro-growth monetary policy strategy. The administered policy interest rate has been reduced by 200 bps to 12.25% over the past four months. Market participants discount further aggressive rate cuts to close this year at 9.5%. Strongly aided by a sharp exchange rate appreciation and a prolonged recession, the headline inflation rate sharply declined to 4.8% y/y (February 2017) from 10.7% y/y (January 2016). A prolonged economic recession together with a distortive interest rate environment provoked a swift reduction in credit activity. Total credit declined to 49% of GDP in 2016 from 54% in 2015 in line with the acute economic contraction.

Brazil's creditworthiness has materially improved, yet local markets remain vulnerable to potential volatility associated with unexpected shifts in monetary policy conditions in the USA. Market metrics in credit default swaps (CDS) imply a sharp reduction in the cost of insurance to hold USD-denominated Brazilian debt assets. In fact, the five-year CDS contract declined to 220 basis points (bps) from 500 bps over the past 14 months. This robust market performance is in stark contrast to the position of international credit rating agencies, all of which maintain a "negative outlook" on their Brazilian sovereign country debt ratings. In this regard, sustained progress on fiscal consolidation and credit quality improvement will be at the core of investor sentiment in the year ahead.

The combination of favourable domestic and external factors led to sustained appreciation of the Brazilian currency which gained 33% against the US dollar (USD) since January 2016. The reversal of the terms of trade shock in the wake of a deep economic recession and favourable financial market conditions in core emerging-market economies fuelled a bullish tone into the BRL. A robust international reserve position (central bank reserves of US$375 billion) coupled with sizeable foreign direct investment flows (US$85 billion in the last 12 months) reasserted the positive exchange rate direction.

CONTACTS

Pablo Bréard, VP & Head of International Economics
416.862.3876
Scotiabank Economics
pablo.breard@scotiabank.com

Chart 1

Sources: Scotiabank Economics, Bloomberg.

Chart 2

Sources: Scotiabank Economics, IBGE.

The process of structural fiscal reform is advancing, yet the fiscal emergency remains in place. The approval of public sector budget cuts coupled with advances in pension system reform is a major step in the right direction. The consolidated public sector deficit remains in gradual adjustment, reaching 8.5% of GDP (January 2017), a positive advance from the near 11% of GDP recorded in January 2016. At the core of such improvement is the sharp reduction in the debt service burden (now at 6.1% of GDP). On a positive note, the external sector adjustment continues to advance with the current account deficit currently at 1.3% of GDP.

The administration of President Michel Temer is focused on introducing the needed policy changes to restart an economy after a deep recession. Meanwhile, the campaign process leading to the October 2018 presidential elections will increasingly become the dominant event shaping the domestic political environment. Meanwhile, Brazil is setting a unique and powerful precedent to address—and prevent—serious public sector misconduct and corruption. The ongoing improvement in the quality of the judiciary cohabiting with a pro-democracy local press will help improve public sector governance in the next political cycle, despite the severe institutional shock caused by the Lava Jato corruption affair.

Colombia

- **The Colombian economy is still performing below its potential.**
- **Colombia benefits from a sharp increase in global risk appetite.**
- **The central bank has adopted a pro-growth monetary stance.**
- **The structural fiscal adjustment remains a key macroeconomic priority.**
- **The electoral cycle will shape the near-term political environment.**

The ongoing correction of the twin (fiscal and current account) deficits is being accompanied by a slower pace of economic activity. Real GDP increased by just 2% in 2016. Looking ahead, a similar rate of economic growth is projected for this year. The necessary fiscal adjustment under way is at the core of the reduction in economic activity with lower contribution from government spending. Weak employment conditions (jobless rate at 11.7% in January 2017) have also eroded consumer confidence during this period of macroeconomic adjustment. Long-term private-sector investment plans may also be delayed ahead of the elections in 2018. It is worth mentioning that the adverse weather shock (torrential rains and mudslides) which caused severe social distress in the Mocoa area (south west of the country) at the beginning of April will be a focus of fiscal relief and reconstruction activity in the months to come.

Colombia is benefiting from a sharp increase in global risk appetite (with an ensuing boost into high-yielding assets) in the wake of the presidential elections in the USA. Market pricing implies a gradual increase in the administered monetary policy rate by the US Federal Reserve, alleviating a potential risk of disruptive contagion waves in the hemisphere. However, given the intensified presence of foreign holdings in local debt markets, Colombia may receive the negative effects of unforeseen changes in emerging market sentiment through the remainder of the year. On the domestic front, investors have welcomed the disinflation trends which led the central bank to adopt a bias towards monetary easing to support growth prospects. The Colombian banking sector remains well capitalized and rigorously supervised. Domestic credit activity remains tied to the economic cycle.

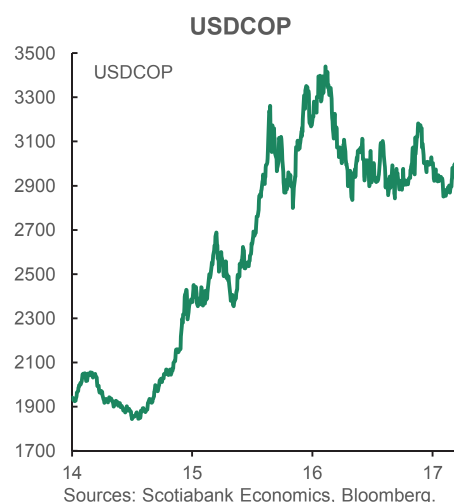
The Colombian peso (COP) has reached a stabilization phase following a recovery phase since mid-November (see chart 1). The primary factors shaping the value of the Colombian currency remain the following: 1) the direction of crude oil prices, 2) the degree of global risk aversion towards emerging markets, and 3) the prospects of monetary policy normalization in the USA with the ensuing impact on the value of the USD vis-à-vis its major peer currencies. Irrespective of the Colombian leadership's strategy to diversify economic structures away from the energy (primarily crude oil) sector, Colombia remains strongly influenced by the direction of energy prices; indeed, the sharp increase in the benchmark WTI price (up 25% since mid-November) was a supporting factor for the local currency in recent months.

The central bank is in monetary stimulus mode. A clear disinflation process has been in place since August 2016, with the rate of consumer price inflation reaching 5.2% y/y in February, down from 9% y/y in July 2016. Lower currency

CONTACTS

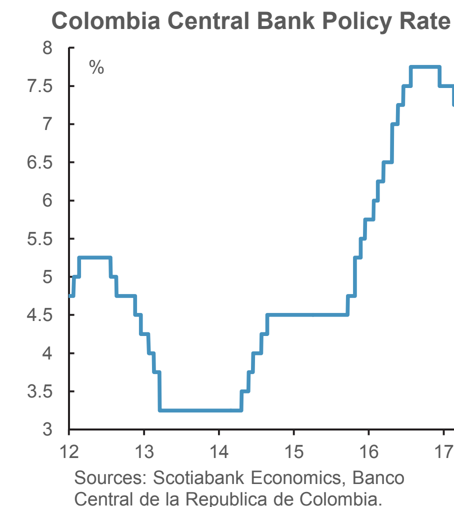
Pablo Bréard, VP & Head of International Economics
416.862.3876
Scotiabank Economics
pablo.breard@scotiabank.com

Chart 1



Sources: Scotiabank Economics, Bloomberg.

Chart 2



Sources: Scotiabank Economics, Banco Central de la Republica de Colombia.

market volatility in the context of recovering terms of trade and food price adjustments reinforced this phase of price stabilization over the past few months. The central bank, which maintains its 3% ± 1% inflation target, reacted in an orthodox manner by adopting a gradual monetary easing bias at a time when economic activity shows persistent evidence of deceleration. The central bank reference rate has been reduced by 50 basis points (bps) to 7.25% over the past three months (see chart 2).

The Colombian economy is making firm advancements in tackling the structural rigidities which led the general government deficit to increase from 2.3% to 4.0% of GDP over the past three years. The combined effect of depleted oil-linked revenue (from 3.3% of GDP to virtually nil) and rising debt service costs (2.9% of GDP) triggered a swift tax reform which received congressional approval at the end of 2016. Looking ahead, this structural reform aims at increasing non-oil revenue by 1.4% of GDP and reducing government expenditures by 0.8% of GDP over the next five years.

Congressional elections, scheduled for March 2018, will be followed by presidential elections two months later. Colombia remains a strategic economic partner and military ally of the USA. As such, the administration of President Santos will continue to receive the diplomatic support of the Trump administration through direct and indirect (IMF assistance) means. As per regional integration with peer economies, the four-member Pacific Alliance initiative will help Colombia implement a trade diversification strategy in the hemisphere. At times, trade, migration and security issues connected with the escalating Venezuelan crisis might provoke situations of bilateral friction.

Peru

- **Adverse weather-related ENSO (El Niño Southern Oscillation) shocks.**
- **Delays in infrastructure projects reduce growth expectations.**
- **Reconstruction efforts to impact fiscal consolidation and boost growth.**
- **Exchange rate stable despite modest ENSO-linked inflationary impact.**

There are three major events impacting the economy in 2017. Two are negative: El Niño, and the political and legal issues surrounding infrastructure investment projects, and one is positive: an increase in fiscal spending.

Since these events are ongoing, their impact on growth is hard to gauge, but will be significant. We are lowering our GDP growth forecast for 2017 from 3.4% to 2.9%, based on the combined impact of the three events, although this may change as the events evolve. What is not impacting growth quite yet, but is a very important positive backdrop, is the sharp improvement in terms of trade.

EL NIÑO

The 2017 El Niño, and the rains, flooding and mudslides it has brought, is one of the four worst ENSO climate events in the last hundred years, together with those in 1925, 1982–83 and 1997–98. The social impact in terms of the number of people affected, houses destroyed, infrastructure damaged, is similar to past mega-Niño. However, the impact on GDP growth will be much weaker. GDP growth was -0.4% in 1998 and -10% in 1983. In contrast, there will not be a recession in 2017, although we'd expect El Niño events to shave off, ceteris paribus, about 0.6 percentage point from growth. There are a number of reasons why the impact of this Niño is mild compared to the past. Unlike the past, the current Niño is an ocean-surface, rather than deep-sea, phenomenon. As a result, there has not been a drought in the south, which is what severely damaged agriculture in the past. Nor have anchovy schools disappeared. In addition, the country, and the world, is healthier. The 1998 Niño occurred in the midst of the Asia crisis. The 1983 Niño occurred during the LatAm debt crisis. The current Niño occurs when the world economy is improving, metal prices are rising, and the country has ample resources for emergency and reconstruction spending (which we quantify in subsequent paragraphs), something that did not exist in the past.

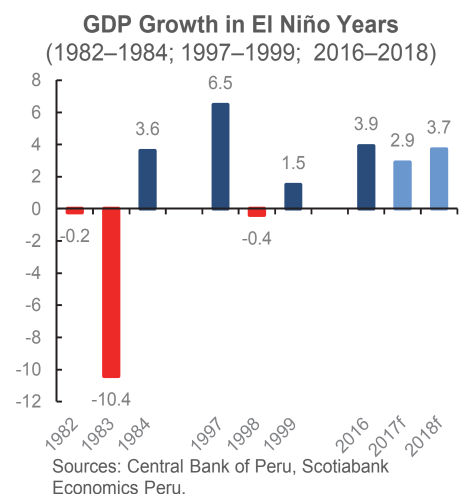
The greatest impact of El Niño will be in construction, with possibly double-digit declines for March and April. On the plus side, there is likely to be an important rebound over a longer horizon, once reconstruction begins in earnest.

Although the impact on mining output has, so far, been minor, this may change given the severe disruption in the transportation of ore, both by train and truck, from the Central Andes to port. Both Volcan and Chinalco have declared force majeure as a result. Most mining companies continue producing near normal levels and stocking up the ore they cannot transport, but there is a limit to this before companies run out of stockpiling capacity.

CONTACTS

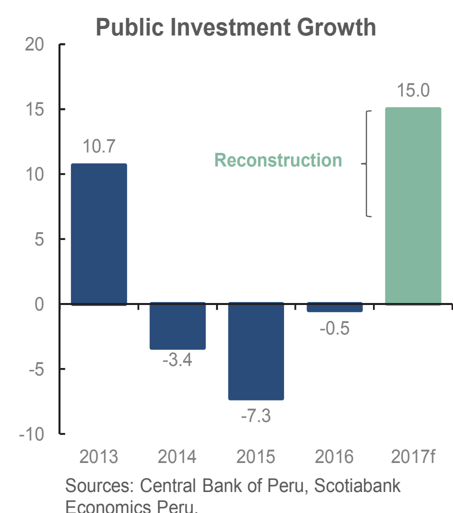
Guillermo Arbe
511.211.6052 (Peru)
Scotiabank Peru
guillermo.arbe@scotiabank.com.pe

Chart 1



Sources: Central Bank of Peru, Scotiabank Economics Peru.

Chart 2



Sources: Central Bank of Peru, Scotiabank Economics Peru.

Flooding has had a material, albeit relatively minor, impact on agro industrial exports, in part because it is mostly offseason. If communications are not restored promptly, however, the impact could be greater.

As for fishmeal production, anchovy schools have been detected within fishing range. Barring any change in this by the late-April fishing season, fishmeal GDP growth should be positive, unlike past Niño events when fishing GDP declined sharply.

The impact on retail and manufacturing for the domestic market should be strongly negative in March–April, but rebound afterwards. Some supply chains have been disrupted, although this will be compensated by the need to replenish destroyed household supplies and retail inventories. The main risk is that small businesses have been affected, with an impact on employment. Although the damage is contained to localities with a relatively small weight in the economy, we expect the aggregate wealth effect to reduce consumption growth from 3.4% to 3.1%.

INFRASTRUCTURE INVESTMENT PROJECTS

When the Kuzcynski administration came into power in 2017, our expectation was that growth in 2017–2018 would be driven by the large infrastructure projects tendered as Public Private Partnerships (PPP) in 2013–14. However, many of these projects are now facing legal and political issues, some linked to irregularities in government procurement programs (the gas pipeline and Chavimochic) and others to controversial tender conditions. We now believe that spending in many of the important infrastructure projects will be delayed until 2019. All in all, we expect growth to be lower by 0.8pp as a result, although part of this was already in our original forecasts.

FISCAL STIMULUS, AND NOW EMERGENCY SPENDING AND RECONSTRUCTION, MEASURES

The delay in PPP infrastructure investment leaves fiscal spending as the main driver of growth. On March 9, just days before the worst of El Niño hit Lima and the northern coast, the government announced fiscal stimulus measures. Among these was an additional USD 1.3bn in fiscal spending. Part of these resources has since been redirected towards disaster relief and reconstruction. Most of the spending will be in roads, schools, irrigation, housing, water & sewage, and security. The government will also expedite to late March about USD 2.7bn in funds for regional and local governments that are normally transferred in June. In all, the government targets 15% growth in public investment in 2017, up from their 5% previously. We believe this target is achievable. This would add 0.3pp to GDP, which is not enough to compensate for the combined impact of El Niño and delays in infrastructure investment.

The combination of effects, then, amount to the following. Our original forecast (which included a 0.6pp loss due to infrastructure spending delays) was 3.4%. Our new forecast of 2.9% accounts for a loss of 0.6pp due to El Niño, a further 0.2pp loss due to infrastructure delays, and a 0.3pp increase due to greater fiscal spending.

STABLE EXCHANGE RATE ENVIRONMENT AMIDST TEMPORARY ENSO-LINKED INFLATIONARY PRESSURES

Transportation disruptions for agricultural goods will impact inflation temporarily. We expect inflation in March to reach 1%, MoM, taking 12-month inflation to near 3.7%. However, eventually agricultural prices will return to their normal levels, so we see no need to alter our year-end forecast of 3.1%. The Central Bank also expects inflation to rise in March, but then return to its 1% to 3% target range by year-end. Julio Velarde, the president of the CB has stated that it will be discussing whether or not to reduce its reference rate in future months. This is new, and in line with its decision to reduce reserve requirements for soles deposits again in April, from 6% to 5%.

It is telling that El Niño has had no impact on the PEN FX market, on country risk or on bond rates. This suggests that financial markets expect Peru's economy to absorb the El Niño shock without too much trouble, and without affecting stability. Increased government spending should drive the fiscal deficit up, but keep it within a manageable level of 3%. The government plans to finance spending mostly with savings and one-off revenue sources. However, they may be underestimating the impact of El Niño on revenue, and we would not be surprised to see the government increasing debt as well.

The PEN has strengthened more than we expected this year, already reaching our end-year level of 3.25. Fundamentals for the PEN continue to improve. Peru's current account surplus in 4Q16, and monthly trade surpluses, together with metal prices, have surprised to the upside. Exports volumes may suffer due to El Niño in March–April, but this will be compensated by higher-than-expected metal prices.

Chile

GLOOMY 2017, A GLIMMER OF HOPE FOR 2018

The Chilean economy grew 1.6% last year, the lowest pace of expansion since the recession of 2009 (-1%). Growth was led by services sectors, like personal services, financial, commerce, transportation and communication, while major contraction came from mining, business services and manufacturing (each sector represents around one third of GDP). Over the last three years, the growth rate has not reached 2.5%, while the long-term growth is estimated around 3%. For the current year, our GDP growth forecast was trimmed to 1.8% because trend indicators in the last quarter of 2016 were much weaker than expected and the economy entered 2017 with a negative tone; indeed, some specific factors are going to negatively impact economic activity (the most important being the long-lasting strike in the biggest copper mine, with more than one and half month loss in output). For the second half, we expect acceleration, due to both statistical and economic factors, some of which are likely to be become more pronounced in 2018. All in all, the balance of risks remains on the downside for the first half of the year, while it looks neutral for the second.

For the next year, the base case for GDP growth is a lukewarm recovery to 2.4%. However, there are factors that could help to instill a faster rhythm. Recovery of business confidence could come from a change in the political scenario towards a more market-friendly policy mix. This factor could ease the implementation of reforms that have been approved in the last years (tax, education, labour, among the most arguable and concerning for growth) and even facilitating other critical reforms, like specific actions to increase productivity in following years and improve the pension fund management system. Besides, there are some subtle economic conditions that help to tilt risks to the optimistic side. Productivity gaps in some sectors have been accumulating during a long time, though not at a very fast rate because investment has been contracting for three years, but enough to look like a rather deflationary factor in the short term. At the same time, inventories have been slashed for three years in a row suggesting that a change in business confidence might spark an accelerated re-building of them. As a backdrop, and not without risks (especially those related with China can't be put aside), the terms of trade situation (exports vs. imports) has been mildly improving, which has empirically proved to be positive for the Chilean economy, not just for trade balance dynamics.

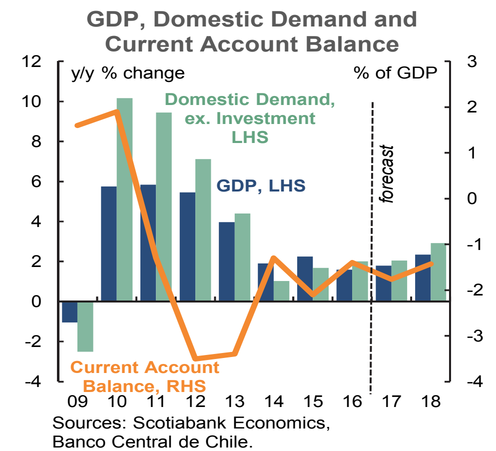
SLUGGISH DEMAND

On the demand side, the outlook remains very similar to that of January for investment, with a 1.1% growth. Our view is favoured by a weaker basis for comparison, considering that investment has been contracting for three years in a row. Now, investment is the most supportive factor linked to energy and infrastructure sectors. A further recovery could be reached in 2018 (3.6%). Regarding consumption, the picture has not changed as much either, though the ongoing weakening of the labour market pushed us to trim our estimated growth rate to 2.3% for the current year and 2.9% for the next. Although the unemployment rate has not climbed dramatically in 2016, some deterioration is

CONTACTS

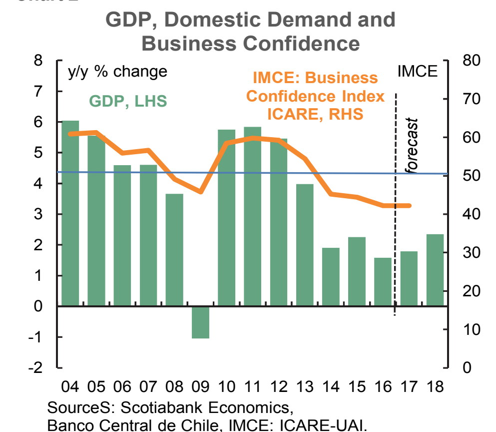
Benjamin Sierra
56.2.2619.4974 (Chile)
Scotiabank Chile
benjamin.sierra@scotiabank.cl

Chart 1



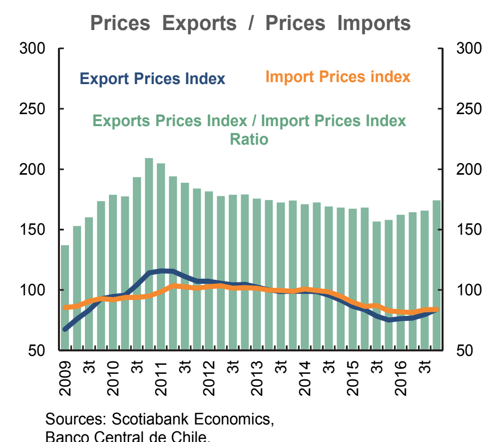
Sources: Scotiabank Economics, Banco Central de Chile.

Chart 2



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

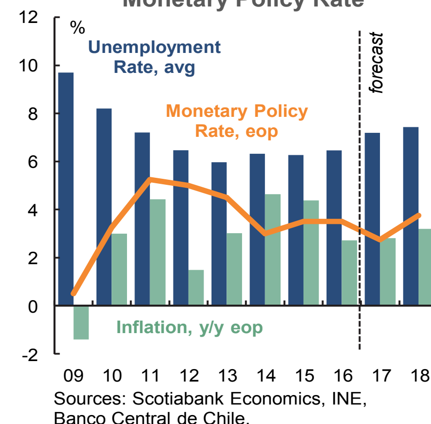
Chart 3



Sources: Scotiabank Economics, Banco Central de Chile.

factored in for the next two years. In the meantime, payroll growth and wages are slowing with the ensuing weakening of household consumption. However, self-employment activity has somewhat offset part of that weakness. Indeed, investment reacts more keenly than consumption to changes in financial and economic conditions. As for our view on the contribution of government spending to economic activity, the budgeted growth of 2.7% seems reasonable, even in an electoral year (please note that presidential elections are scheduled for November 2017).

Chart 4

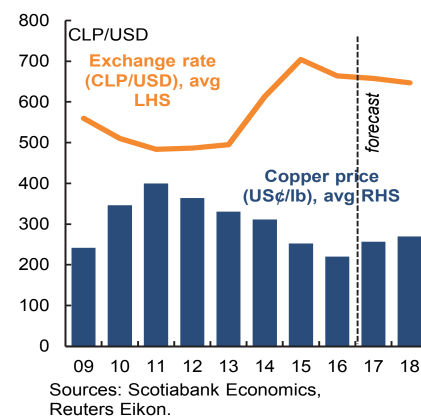


Sources: Scotiabank Economics, INE, Banco Central de Chile.

TAMED INFLATION, MONETARY POLICY ALMOST AT LIMIT, HARMLESS EXCHANGE RATE

Productive gaps, slowing salary adjustments, a relatively stable exchange rate and inflation indexing schemes are factors enough to project an inflation rate of 2.8% in 2017, similar to that of 2016 (2.7%). However, estimated oil price hikes and other commodities plus a more reflationary monetary policy should help the headline inflation rate to pick up to 3.2% in 2018. Indeed, the Central Bank increased the monetary policy stimuli in the first quarter (two 25bp cuts, to leave the monetary policy rate at 3%); looking ahead, we expect one more reduction in May or June. Nevertheless, there is not much more room for additional cuts and the effect of reflationary policies does not seem the most decisive to get some recovery of activity. On the other side, a rate hike at the very end of the current year, though is not our base case, should be in the cards if some change in expectations takes place over the next months. Regarding the exchange rate (CLP/USD), we do not expect very dramatic deviations in coming quarters, though a relatively wide range similar to that started in August should prevail, between 640 and 680. The most critical factors for the value of the peso will be copper prices and the USD international value.

Chart 5



Sources: Scotiabank Economics, Reuters Eikon.

ELECTIONS ENTERING HOT SEASON

Partial Congress elections and the first round of presidential will take place on November 19th (the run-off vote of the Presidential election—a very likely occurrence—would be on December 17th). So far, the highest probability is for a race between former President Sebastián Piñera (center-right and very pro-market) and, the ruling coalition, Senator Alejandro Guillier (a social democratic sociologist and journalist). Other candidates in both sectors are far behind them (including former center-left President, Ricardo Lagos, who had been in the run since September). Mr. Piñera keeps an advantage over Mr. Guillier, whose campaign has been losing some steam lately. Nothing will be quite clear before mid-year because the ability of each coalition to be well-aligned behind its candidate will be critical. Summing up, the political environment conveys a high political risk, though not necessarily in a negative sense, but its potential effect on economic variables looks higher than usual. Anyway, beyond the result of the election, the ability of forces to get agreement to improve the quality of public policies will be critical in coming years.

China

- **China increases its economic might by output growth outperformance.**
- **Economic, financial, and social stability prioritized in 2017.**
- **Monetary policies focus on encouraging gradual deleveraging.**

CHINA'S ECONOMIC REBALANCING CONTINUES GRADUALLY

The Chinese economy has started the year with solid momentum, as implied by recent high-frequency indicators from the industrial and services sectors. However, authorities have emphasized financial stability over fast economic growth and lowered the 2017 real GDP growth target slightly to around 6.5% from 6.5–7% in 2016. According to policymakers, increased attention will be paid to deleveraging and managing financial risks related to non-performing assets and high corporate leverage, bond defaults, shadow banking, and the heated real estate market (chart 1).

China's real GDP growth will continue to decelerate gradually on the back of ongoing structural economic transition. We expect the nation's output gains to slow toward 6% y/y in 2018 (chart 2). Despite the deceleration, we highlight that the expansion of around 6% is substantial and will continue to increase China's economic significance in the world: if such momentum is maintained through the rest of the decade, the addition to China's GDP between 2015 and 2020 will be equivalent to the combined economies of Brazil, Russia, and India.

While the Chinese government will continue its sizeable fiscal injections in infrastructure, overall activity will be increasingly driven by the Chinese consumer and the services sector. Household spending is supported by rapidly expanding incomes; the number of upper middle-class and affluent households is estimated to reach 100 million by the end of the decade, doubling from the 2015 level. Regardless of China's gradual structural change and the rise of the consumer, the external sector still remains highly relevant as the nation's exports are equivalent to almost 20% of GDP. The US is China's main trading partner, purchasing a fifth of Chinese exports. Therefore, any trade policy changes toward increased protectionism in the US, such as high tariffs on Chinese goods shipped to the US, would have an adverse impact on China's economic performance.

LEADERSHIP RESHUFFLE AT END-2017 LIMITS REFORM PROGRESS

Official statements imply that the Chinese policymakers are determined to reduce the economy's sizeable imbalances, such as credit-fuelled growth and high corporate leverage as well as asset bubbles and inadequate pricing of risk. Nevertheless, we do not expect significant progress this year, given that the 19th National Congress of the Communist Party of China will take place at the end of this year and the government prefers economic, financial, and social stability ahead of this important twice-a-decade leadership reshuffle.

Rapid money supply growth over many years, combined with capital controls that are preventing effective large-scale diversification of assets abroad (chart 5), has fed the build-up of bubbles in various parts of the economy—including the real

CONTACTS

Tuuli McCully
65.6305.8313 (Singapore)
Scotiabank Economics
tuuli.mccully@scotiabank.com

Chart 1

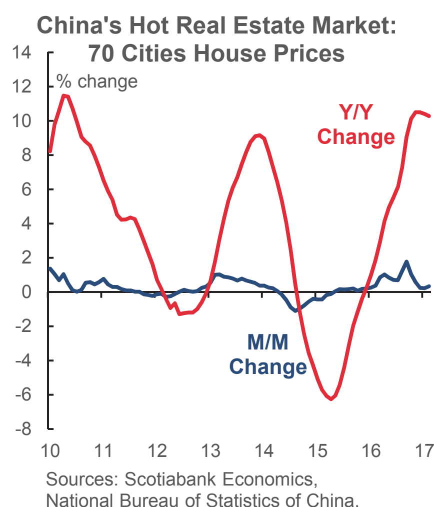
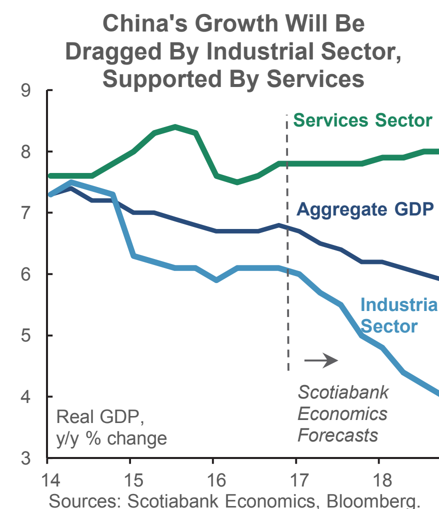


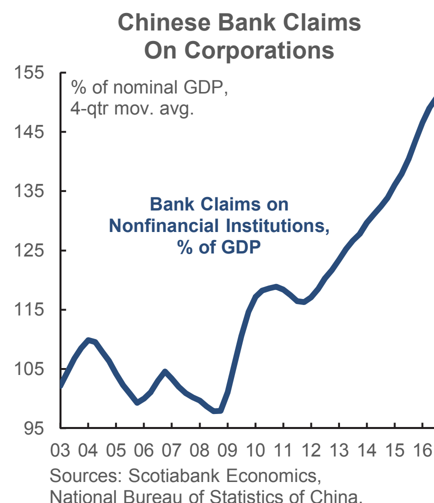
Chart 2



estate sector and the shadow banking industry—and created sizeable vulnerabilities, such as the fragility of the banking sector health due to a massive corporate debt overhang (chart 3). Regrettably, the government's recent actions—tightening capital controls even further and increasing public outlays to keep output growth at an artificially high level of 6.5%—are counterproductive from the bubble-reduction point of view.

The Chinese government prefers incrementalism in its reform execution in order to maintain social stability. Evidently, it is moving forward in some areas, while retreating in others. Addressing pressing domestic issues (such as industrial overcapacity, excessive corporate leverage, restructuring of state-owned enterprises, and financial system reform) gradually and without triggering a significant growth slowdown takes time and requires a favourable global backdrop that provides growth support from the external side. In this context, the ongoing strengthening of global economic momentum would bode well for China should it take a more unwavering approach to reforms in 2018 once the new leadership structure is in place.

Chart 3

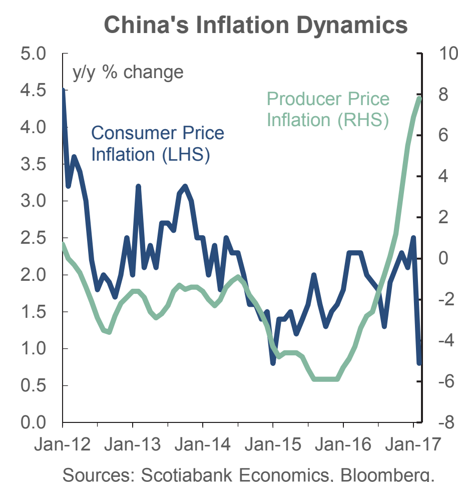


Sources: Scotiabank Economics, National Bureau of Statistics of China.

GRADUAL MONETARY TIGHTENING IN SIGHT

Recent actions by Chinese monetary policymakers demonstrate success in limiting credit growth and promoting financial deleveraging. Following the US Federal Reserve's interest rate hike, the People's Bank of China (PBoC) raised interest rates on its open-market operations by 10 basis points in mid-March. This was the second increase in the current tightening cycle and follows a similar hike in February. The 7-day reverse repo rate, which can be interpreted as the PBoC's de-facto policy rate, is now 2.45%. Meanwhile, the official benchmark rates—the one-year loan and deposit rates—have been kept at 4.35% and 1.50%, respectively, since October 2015. In our view, the key reasons for the PBoC's fine-tuned tightening are the overheating real estate market in certain cities, fast credit growth, as well as aspirations to limit weakening pressure on the renminbi ahead of the year-end leadership meeting. At the same time, the central bank aims to maintain a growth-supportive monetary policy stance. We expect the PBoC to tighten monetary conditions further over the course of 2017 by targeted policy measures. Nevertheless, we do not anticipate any changes to the official benchmark rates.

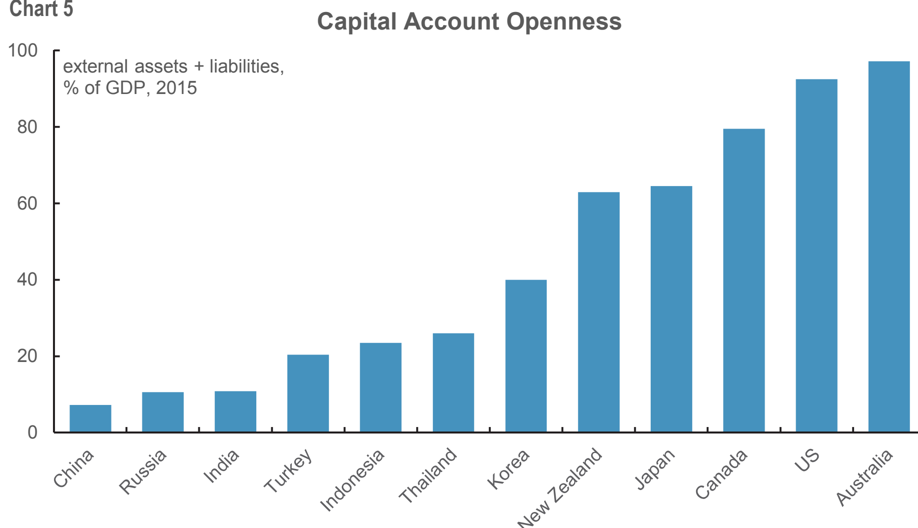
Chart 4



Sources: Scotiabank Economics, Bloomberg.

Chinese inflation is expected to remain manageable. Headline consumer price inflation eased to 0.8% y/y in February from 2.5% in January (chart 4), yet it is set to rebound over the coming months. The significant drop reflected sizeable year-over-year reductions in food prices given the shifting timing of the Lunar New Year, which was celebrated in January this year and in February in 2016. We expect annual inflation to close 2017 at around 2¼% and 2018 at 2½%. Producer prices have recently risen significantly (7.8% y/y in February), yet their pass-through to consumer prices is expected to be relatively limited. Producer price gains reflect the Chinese government's efforts to reduce industrial overcapacity, increased public infrastructure spending, as well as the recent rally in commodities futures markets.

Chart 5



Sources: Scotiabank Economics, IMF International Investment Position.

Japan

- **Strengthening global activity together with accommodative monetary and fiscal policies underpin economic growth.**
- **Minimal wage growth keeps inflationary pressures low.**

ABOVE-POTENTIAL REAL GDP GROWTH

Stimulative fiscal and monetary policies will continue to support the Japanese economy through 2018, with real GDP gains exceeding the country's low potential growth of less than ½% y/y. We expect Japan's output to grow by 0.9% y/y on average in 2017–2018 following a 1.0% gain in 2016. Nevertheless, we assess that the current growth momentum is not sustainable in the medium-to-long term without decisive implementation of structural reforms that would raise Japan's productivity, labour supply, and potential output growth.

The Japanese external sector is responding to strengthening global activity with export volumes (in year-over-year terms) rising faster than imports in recent months. The pick-up reflects stronger demand from Asia, particularly in China. The export recovery should add further impetus to rising corporate profits, which we expect to provide some support to business investment over the coming quarters. The Japanese government's fiscal measures and tight labour market conditions will support consumer spending. At 3.0%, Japan's current jobless rate exceeds the estimated natural unemployment rate of 4.3% by a wide margin. Accordingly, the tight labour market should eventually feed faster wage gains (real wage growth was 0% y/y in January); nevertheless, in order to support consumer spending prospects in a sustainable fashion, structural reforms are needed to remove labour market rigidities and to reverse the trend of rising part-time and contract employment.

BELOW-TARGET INFLATION

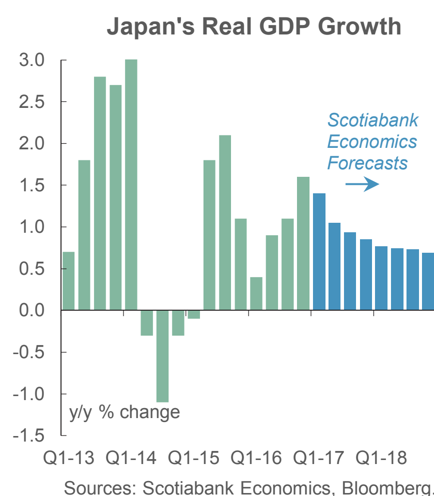
Accommodative monetary and fiscal policies will remain the norm in the foreseeable future, as they buy time for slowly progressing reform implementation. We expect the Bank of Japan's (BoJ) short-term policy rate and the 10-year yield target to be kept at -0.1% and "around 0%" over the coming months. Most recently in mid-March, the central bank reaffirmed its commitment to continue to expand the monetary base until annual CPI inflation (all items less fresh food) "exceeds 2% and stays above the target in a stable manner". Japan's fiscal profile remains structurally weak, yet any fiscal consolidation will be slow as economic revival takes priority. The government's budget for fiscal year 2017–18 (April–March) is record high at ¥97.45tn, as rising social security payments due to population ageing necessitate an increase in public outlays.

Japan's headline inflation was 0.3% y/y in February. The BoJ's preferred CPI measure (excl. fresh food) has emerged from deflationary territory and rose to 0.2% y/y. Nevertheless, temporary downward pressure on prices will likely re-emerge in the near term. We estimate that the headline inflation rate will climb to 0.8% y/y by the end of 2017 and 1.1% by end-2018. Given still-subdued wage growth, meeting the BoJ's 2% y/y inflation target lingers far in the future.

CONTACTS

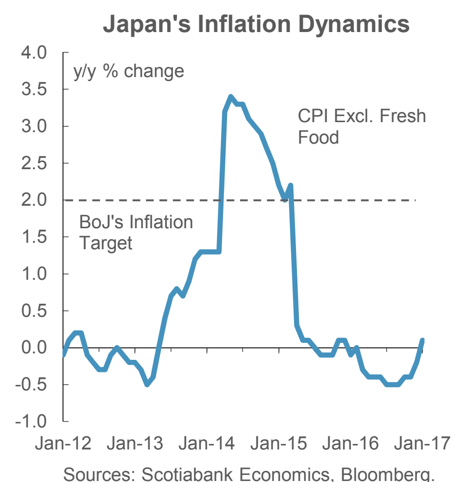
Tuuli McCully
65.6305.8313 (Singapore)
Scotiabank Economics
tuuli.mccully@scotiabank.com

Chart 1



Sources: Scotiabank Economics, Bloomberg.

Chart 2



Sources: Scotiabank Economics, Bloomberg.

India

- **Stronger economic fundamentals and expectations for continued structural reform support India's real GDP growth.**
- **Monetary and fiscal policy credibility will enhance investor confidence.**

DOMESTIC DEMAND TO DRIVE INDIA'S ECONOMIC GROWTH

India's outlook is improving as the economy recovers from the temporary cash shortage that followed the government's currency exchange initiative at the end of 2016. We expect India's real GDP growth to average 7¾% y/y in 2017–18 following a 7½% advance in 2016. Momentum will be driven by domestic demand—particularly household spending—on the back of India's rapidly expanding middle class and rising disposable incomes, as well as enhancements to the business environment following implementation of key reforms. Simultaneously, India's macroeconomic stability is improving, reflecting contained inflation, improved fiscal position, and reduced external vulnerabilities.

In addition to stronger fundamentals, India's political environment is set to support the economy's prospects. Legislative Assembly elections were held in five states at the end of February and early March; Prime Minister Narendra Modi's Bharatiya Janata Party (BPJ) performed well, which will improve the party's position in the upper house of parliament where it currently lacks a majority. Expectations for smoother passage of key structural reforms will enhance investor confidence and appetite toward India over the coming quarters.

SUPPORTIVE — YET PRUDENT — MONETARY AND FISCAL POLICIES

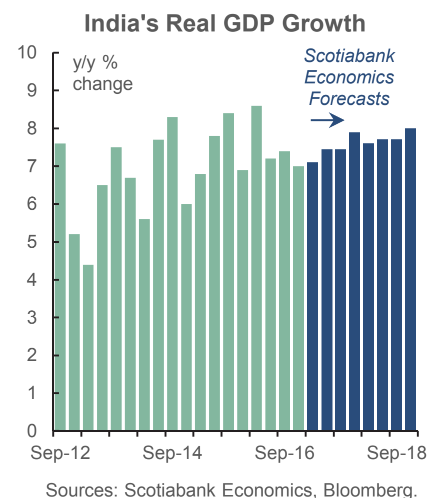
India's monetary and fiscal policies are set to be growth-supportive while remaining cautious enough to ward off the build-up of strong inflationary pressures and fiscal slippage. We expect India's monetary conditions to remain unchanged over the coming quarters; indeed, the Reserve Bank of India (RBI) announced in February that it has changed its monetary policy stance from accommodative to neutral. The benchmark repo and reverse repo rates have been left unchanged at 6.25% and 5.75%, respectively, since October 2016. The RBI's commitment to inflation targeting will help anchor inflation expectations and improve policy credibility. India's inflation outlook is favourable; while we expect inflation to pick up over the coming months from the February level of 3.7% y/y, price gains are set to remain within the RBI's inflation target of 4% ± 2% y/y through 2018.

The Union Budget 2017–18 (April–March), unveiled on February 1, is growth-supportive while remaining committed to gradual fiscal consolidation. Government spending will mostly be directed at infrastructure improvements and the rural economy. The administration's goal of narrowing the central government deficit to 3% of GDP was delayed by one year until FY2018–19. The public deficit remains larger at the general government level, averaging 6½% of GDP in 2017–18. The Indian administration aims to roll out a nationwide Goods and Services Tax in July 2017. This important tax reform will transform the economy into a single market and improve the nation's cumbersome business environment.

CONTACTS

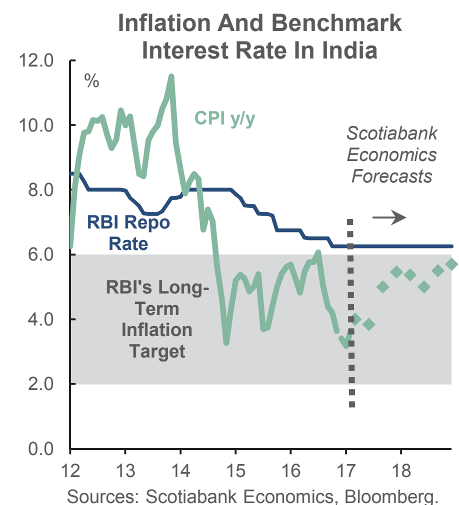
Tuuli McCully
65.6305.8313 (Singapore)
Scotiabank Economics
tuuli.mccully@scotiabank.com

Chart 1



Sources: Scotiabank Economics, Bloomberg.

Chart 2



Sources: Scotiabank Economics, Bloomberg.

Australia

- **External sector drives near-term momentum; domestic demand key for longer-term growth.**
- **Accommodative monetary conditions will support structural transition.**

AUSTRALIA'S ECONOMIC TRANSITION CONTINUES

Australia will continue to be a strong performer among its advanced economy peers through 2018, yet the outlook is not without its own country-specific challenges. Australia's real GDP advanced by 2.5% in 2016 as a whole; the economy rebounded in the final quarter of 2016 from the slump recorded in the July–September period, with real GDP growing by 1.1% q/q (vs. -0.5% q/q in the third quarter). We estimate that the Australian economy will continue to expand in line with its potential growth rate of around 2½% y/y in 2017–18.

Australia's near-term economic growth prospects are favourable, yet momentum is partially supported by transitory factors in the external sector. The country's mining boom has moved from an investment phase to a production phase. Therefore, higher export volumes are providing a temporary boost to the economy. A pick-up in commodity prices from year-earlier levels is raising Australia's terms of trade, underpinning corporate profits, and output growth. However, we assess that the medium-term pricing environment for LNG, iron ore, and metallurgical coal is unlikely to improve. Finally, Australian exporters are benefitting from the recent stabilization of the Chinese economy, a destination for almost 30% of Australia's exports; in the medium-term, however, they remain vulnerable to the inevitable slowdown in China's commodity import demand.

The external sector growth factors play a key role in smoothing out the Australian economy's ongoing rebalancing toward non-mining-based activity. As their contribution to growth diminishes over the coming quarters, Australia's longer-term outlook will increasingly rely on the strength of consumer spending and non-mining investment. Low interest rates, rising household net wealth, and gradually rising employment are supporting consumer spending, yet muted wage gains and a high household debt burden will limit consumption growth somewhat. We expect a pick-up in non-mining investment over the coming quarters, which reflects higher residential construction activity and public infrastructure outlays.

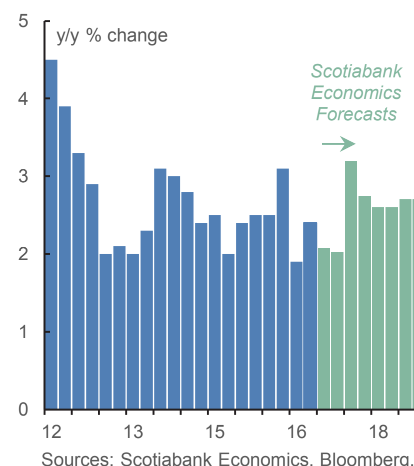
CONTAINED INFLATION ALLOWS FOR LOOSE MONETARY CONDITIONS

Slack in the Australian labour market will continue to keep wage increases and demand-driven inflation low. Mostly reflecting higher commodity prices, Australia's headline inflation rate will likely climb to over 2% y/y in early 2017 from 1.5% y/y at end-2016, reaching the Reserve Bank of Australia's (RBA) inflation target of 2-3%. Given our expectations for gradually increasing price pressures—albeit at the headline level only—together with our cautious optimism about Australia's full-time employment prospects, we assess that the RBA's monetary easing cycle has come to an end. Nevertheless, we anticipate that the central bank will maintain the current accommodative monetary policy stance over the coming quarters in order to support domestic demand and the economy's structural transition. A cautious monetary tightening phase will likely commence in the latter half of 2018.

CONTACTS

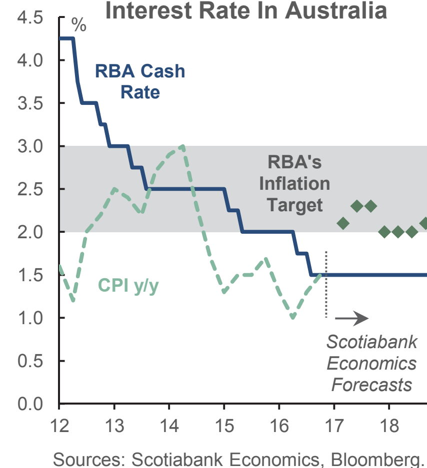
Tuuli McCully
65.6305.8313 (Singapore)
Scotiabank Economics
tuuli.mccully@scotiabank.com

Chart 1



Sources: Scotiabank Economics, Bloomberg.

Chart 2



Sources: Scotiabank Economics, Bloomberg.

Commodities

- **Industrial commodities will continue to benefit from healthy demand on the back of a stronger global economic outlook, while supply-side idiosyncrasies continue to provide opportunity for differentiation.**

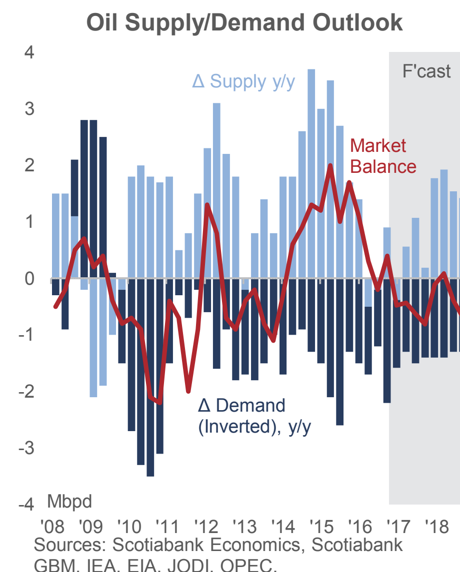
CONTACTS

Rory Johnston
416.862.3908
Scotiabank Economics
rory.johnston@scotiabank.com

OIL: RECOVERY IS RUNNING A BIT BEHIND

The oil market recovery remains on track but fragile, and bearish sentiment is likely to weigh on prices until our more bullish fundamental outlook is confirmed by US inventory draws over the coming months. We have **downgraded our WTI price forecast to $53/bbl in 2017 ($58 prior) and $56/bbl in 2018 ($61 prior)** given a stronger US shale outlook, Brazilian output gains temporarily supporting non-OPEC supply outside the US, and stubbornly-high US inventories which have taken longer than anticipated to draw. Our base case outlook is for physical balances to move into deficit (chart 1) for the remainder of 2017, and we see four main factors driving the near-term outlook: 1) OPEC output discipline, 2) the pace of US shale response, 3) non-OPEC production declines outside the continental US, and 4) the strength of consistently underestimated global demand growth.

Chart 1



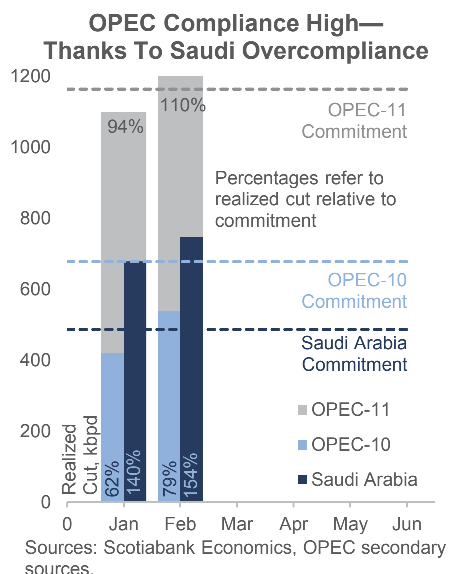
Sources: Scotiabank Economics, Scotiabank GBM, IEA, EIA, JODI, OPEC.

OPEC: SIX-MONTH EXTENSION OF PRODUCTION DEAL EXPECTED

More than two years after abandoning the role of market manager to "market forces", OPEC attempted to take back the reins late last year and 11 members—all but Libya and Nigeria, which were exempt due to domestic militancy—committed to reducing collective output by roughly 1.2 Mbpd, effective January. We're now in the third month of those cuts, and compliance within the OPEC-11 has been surprisingly strong (chart 2). While this high rate is skewed by higher-than-committed Saudi Arabian reductions, the physical market effect is the same, though it leaves the deal more vulnerable to Saudi charges of freeriding. A possible early sign of such a crack forming was seen in OPEC's latest monthly report, which showed a discrepancy between the standard "secondary source" estimates of Saudi production in February, which were lower on the month, and the "direct communication" provided by Riyadh, which showed production climbing by more than a quarter-million barrels per day from January. This could be a statistical warning-shot to OPEC free-riders, or it could, as a Saudi statement claims, have simply reflected temporarily higher production destined to replenish domestic inventories that would have no direct effect on market balances.

OPEC headlines will continue to drive near-term market sentiment, particularly as the group prepares to meet on May 25th to decide whether to maintain cuts—scheduled to expire in June—for another six months. OPEC oil ministers have repeatedly referenced the level of OECD petroleum inventories relative to their five-year average as a gauge of the rebalancing. Those inventories were more than 280 Mbbl above their five-year average as of January and, while European stocks have been falling into a healthier range, the same cannot be said of industry stocks in the US. **We believe that the combination of high OECD inventories, still-weak upstream investment outside the US, and recent oil price weakness will prompt OPEC to extend their production cap through the end of the year**.

Chart 2



Sources: Scotiabank Economics, OPEC secondary sources.

The supply glut that began in mid-2014 has dumped almost one billion barrels of petroleum into global inventories, of which only 35–45% ended up in transparent

OECD tanks. However, the majority of the remainder was absorbed by China's growing strategic petroleum reserve (SPR), meaning that the lion's share of functional—and thus needing to draw from an OPEC perspective—industry inventories remain in the OECD, and specifically in the US (chart 3). We expect state-side stocks to begin drawing in Q2 as refineries come out of maintenance and the lagged shipping of OPEC crude begins to reflect observed cuts.

US SHALE: ROARING REBOUND ON TRACK TO REACH 1 MBPD Y/Y GROWTH BY YEAR-END

US shale production grew by more than 3.25 Mbpd over the three years to 2014, flooding the market and setting the stage for OPEC's decision to abandon its role as market manager, at least in part an attempt to kill off the novel source of unconventional supply. Plunging prices took an axe to the US rig count and the short-cycle nature of shale supply led to a relatively quick drop-off in lower-48 crude output. The downturn forced the US shale patch to do more with less—it was either that, or go out of business. Operating costs fell precipitously, priming the industry for a strong rebound once prices began rising again.

That rebound has continued to surprise on the upside—prompting the Energy Information Administration (EIA) to repeatedly upgrade their forecast—and US crude production is on track to reach growth of 1 Mbpd y/y by December, per Scotiabank GBM estimates (chart 4). Even the recent drop in oil prices is unlikely to stall the uptrend, with many companies having hedged the majority of their year-ahead production when prices were trading in the $50–55/bbl range. Cost inflation may become an inhibiting factor with the industry running this hot but we have yet to see evidence that it has become a major factor thus far. Beyond the optimistic outlook for US production, non-OPEC supply outside the US is where we expect to see global upstream capex reduction bite hardest.

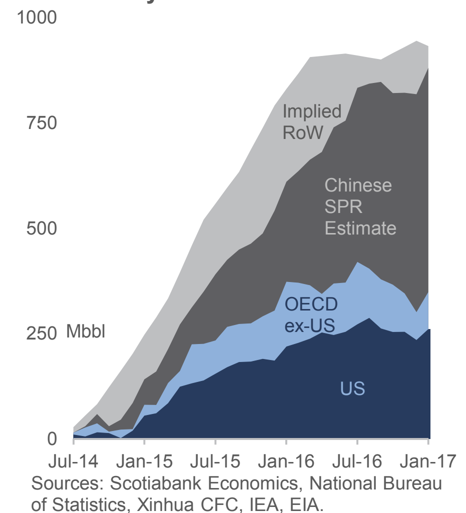
NON-OPEC EX-US: DECLINES EXPECTED DESPITE TEMPORARY STRENGTH ON BRAZILIAN GAINS

While market attention has gravitated to the OPEC rumour mill and the excitement of US shale, non-OPEC countries outside the US and Canada remain a larger but slower-moving factor in future supply. Recent strength in Brazilian production—averaging 300 kbpd y/y growth from September to February as pre-salt production ramps up—has offset broader weakness in the rest of this "other" category, where supply contractions have averaged almost 400 kbpd (chart 5). This production group will be essential to meet future supply needs and is nearly equal to OPEC in size. It is also this group that is likely to feel the brunt of the precipitous decline in upstream investment, as a weakened international oil industry pulls back from megaprojects and other capital-intensive ventures in deep water, the arctic, and frontier markets. These longer-cycle projects typical of the industry standard even 3 years ago will by their nature decline more slowly than what we witnessed over the past year in the US shales, but will take time to turn positive again now that supply is trending down.

DEMAND: CONTINUED STRENGTH ON GLOBAL ECONOMIC ACCELERATION, STILL-LOW PRICES

Despite the drama on the supply side of the ledger, demand growth is of equal importance to the question of when the oil market returns to deficit and begins drawing down the inventory overhang. The International Energy Agency (IEA) estimates that demand grew by 1.6 Mbpd last year, though that estimate is up from 1.2 Mbpd in January 2016; similarly, IEA demand growth forecasts for 2015 started the year at 0.9 Mbpd have subsequently been raised to 2.0 Mbpd. The IEA currently expects demand to rise at 1.4 Mbpd in 2017, but those numbers are also likely to move up through the year as more accurate data became available, further tightening the market against expected supply growth of only 0.4 Mbpd.

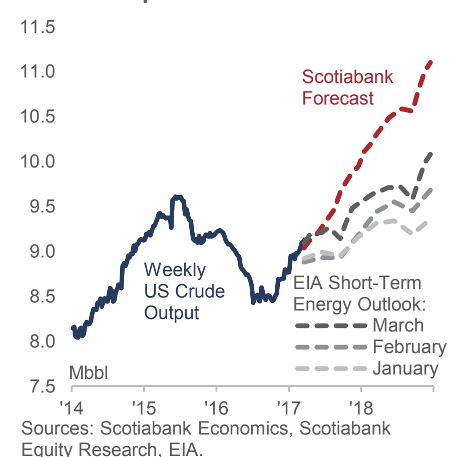
Chart 3 Where's the Oil? Inventory Builds Since June 2014



Sources: Scotiabank Economics, National Bureau of Statistics, Xinhua CFC, IEA, EIA.

Chart 4

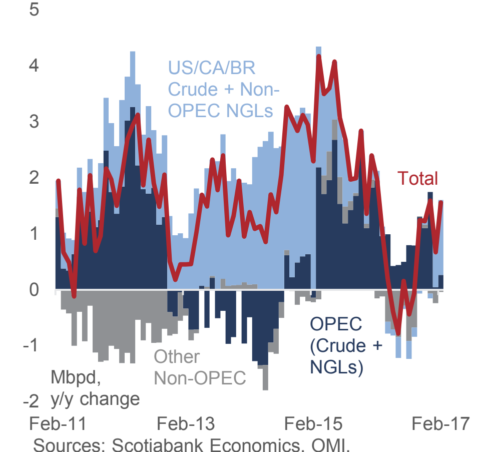
US Crude Production Expected To Outpace EIA Forecasts



Sources: Scotiabank Economics, Scotiabank Equity Research, EIA.

Chart 5

US/CA/BR Supply Strength Masking Broader Non-OPEC Weakness



Sources: Scotiabank Economics, OMI.

METALS & MINERALS: SUPPLY-SIDE FACTORS PROMPT COPPER/ALUMINIUM UPGRADES, NICKEL DOWNGRADE

The metals outlook remains split between the increasingly bullish outlook for the base metals and the ongoing correction in the prices of bulk commodities. For a more in-depth discussion of the major factors that will drive these commodities over the coming years, see last month's Special Report: Digging Deep Into Metals & Minerals. The following will provide updates to the key uncertainties mentioned in that report and provide fresh price forecasts in line with our view of shifting fundamentals.

We have **upgraded our copper price forecasts to $2.50/lb in 2017 and $2.65/lb in 2018** given that disruptions at the Escondida and Grasberg mines, which account for a combined 10% of global capacity, have lasted longer than previously anticipated. While both disruptions now appear to have been at least partially resolved, we are now assessing the potential for further losses at Cerro Verde, Peru's largest copper mine. The combination of already-high production loss, continued supply uncertainty, and the potential for stronger Chinese demand ahead of the National Congress later this year are all near-term bullish for copper prices.

Aluminium prices have also seen considerable upward momentum over the past month due to announced plans to idle significant smelting capacity in China over the winter months in an effort to address chronic smog issues. Beijing has a history of only partially following through on environmental policy plans, particularly when they run counter to industrial goals. However, if fully implemented, these "blue sky" policies could take upward of 2–3 Mt of primary aluminium supply off the market and flip market balances from moderate surplus to moderate deficit in 2017. **Prices are now forecast to average $0.85/lb in 2017 and 2018**, up from expectations for sub-$0.80/lb performance prior to the announcement by Chinese authorities.

Zinc remains the metal with the strongest fundamentals, and the tightness in zinc concentrate markets continues to be confirmed by falling treatment charges, which are inversely related with concentrate supply. From an average of over $200/t in 2015/16, benchmark treatment charges have fallen to below $30/t as of February. Severe flooding in Peru, the world's second-largest miner of zinc concentrate, has damaged transportation infrastructure, hampered export capacity, and may further tighten near-term concentrate balances. **Zinc prices are forecast to average $1.35/lb in 2017 and $1.55/lb in 2018**.

Nickel supply received another potential shock as Philippines President Duterte raised the possibility of banning all domestic mining activity in the world's largest exporter of nickel ore. This follows orders to shutter roughly half the country's nickel mine capacity after many failed environmental audits. However, while we certainly believe that the market needs to prepare for less tonnage out of Philippine ports, considerable inventory overhangs and potential Indonesian supply flexibility make this issue less concerning than it may seem at first. **Nickel prices are forecast to average $5.00/lb in 2017 and $5.50/lb in 2018**.

The outlook for gold remains weighed down by a rising interest rate environment, with shifting risk appetites likely worth $50/oz within the $1200–1300/oz range. The worries of a rising populist tide in Europe have subsided after far-right disappointment in the Dutch election and polling ahead of the French election increasingly favours more establishment candidates. Meanwhile, the failure of the Trump administration and the GOP-controlled Congress to pass healthcare legislation may provide a preview of what is ahead on tax reform, testing the foundation of the post-election market rally. **We see gold prices averaging $1200/oz in 2017 and $1250/oz in 2018** given a mix of mildly bearish interest rate fundamentals and a balanced risk outlook.

Table 1 — Commodities

	2000–2015			Annual Average		
	Low	Avg.	High	2016	2017f	2018f
WTI Oil (USD/bbl)	17	64	145	43	53	56
Brent Oil (USD/bbl)	18	67	146	45	56	59
Nymex Natural Gas (USD/mmbtu)	1.75	5.09	15.38	2.55	3.10	3.05
Copper (USD/lb)	0.60	2.36	4.60	2.21	2.50	2.65
Zinc (USD/lb)	0.33	0.81	2.10	0.95	1.35	1.55
Nickel (USD/lb)	2.00	7.45	24.58	4.36	5.00	5.50
Aluminium (USD/lb)	0.56	0.87	1.49	0.73	0.85	0.85
Iron Ore (USD/tonne)	17	68	187	58	65	55
Metallurgical Coal (USD/tonne)	39	127	330	115	170	130
Gold, London PM Fix (USD/oz)	256	845	1,895	1,251	1,200	1,250

Foreign Exchange

CAUTIOUSLY OPTIMISTIC ON THE US DOLLAR

The **US dollar (USD)** advanced to a 14-year high in January but spent much of the rest of Q1 backtracking and consolidating those gains. We expect the USD to regain strength through the coming quarter as the Federal Reserve continues its gradual policy normalization and the US economy pushes ahead after a bumpy start to the year where weather-related factors may have dampened growth somewhat relative to prior expectations. Business and consumer sentiment readings are running strong following the US election last November and, despite the setback over healthcare reform, we expect the Trump administration to push ahead with its pro-growth agenda which will keep the Fed on track to raise interest rates at least twice more this year.

Even considering the recent pull-back in US yields, we think the USD has a little catching up to do to reflect the shift in relative policy that has already occurred. US yields are significantly higher than those of the USD's main peers and we estimate the USD index (DXY) is roughly 3% undervalued versus the level at which weighted rate differentials (based on the components of the DXY) suggest the USD should be trading. The USD is now one of the top-yielding major currencies in the world (only the NZD and AUD offer better returns). Higher yield premiums make the USD attractive to buy for speculative investors but more costly to sell for corporate and institutional hedgers. We think the recent softening in the USD can only go so far before buyers step back in.

The **Canadian dollar (CAD)** has benefited from a run of stronger-than-expected data in the early part of the year that possibly does not fully reflect some of the ongoing challenges in the composition of and momentum behind domestic growth. Trade data has shown a return to surplus, but growth in non-energy exports remains weak (-4.4% y/y in real terms in January). Domestic businesses also appear concerned about potential challenges in trading with the US going forward, which may hamper the long-awaited strengthening in business investment in Canada. With trade struggling and capital spending plans poised to remain weak, domestic consumer demand and housing will have to continue doing much of the heavy lifting on growth in the coming months.

We think the poor composition of growth and excess capacity, which will keep domestic price pressures subdued, effectively rules out any Bank of Canada (BoC) rate increase through mid-2018 at least. Short-term rate differentials between the US and Canada are poised to remain adverse (for the CAD) for the foreseeable future. With crude oil softening amid signs that US shale producers are stepping up output, the prospect of a significant rebound in energy prices providing more support for the CAD in the near-to-medium term looks remote.

For the other major currencies, like the **euro (EUR), sterling (GBP) and yen (JPY),** low yields, easy central bank policy and domestic challenges are clear impediments to gains. The European election cycle remains in focus (with France and Germany due to vote), even though the Dutch general election result suggested that the advance of populism may not be as significant as previously thought. Low core inflation and weak inflation expectations suggest to us that talk of rate increases in the Eurozone remains premature.

CONTACTS

Shaun Osborne, Chief Currency Strategist
416.945.4538
Foreign Exchange Strategy
shaun.osborne@scotiabank.com

Qi Gao
65.6305.8396 (Singapore)
Foreign Exchange Strategy
qi.gao@scotiabank.com

Eduardo Suárez
5255.9179.5174 (Mexico)
Foreign Exchange Strategy
eduardo.suarez@scotiabank.com

Eric Theoret
416.863.7030
Foreign Exchange Strategy
eric.theoret@scotiabank.com

Chart 1

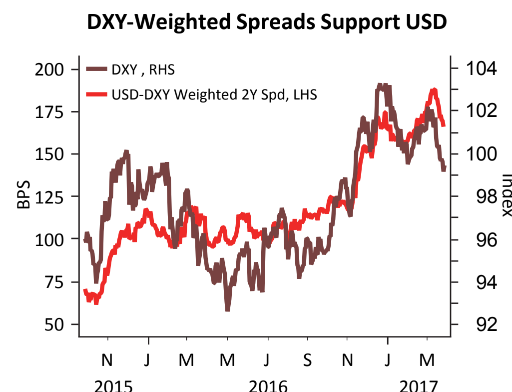
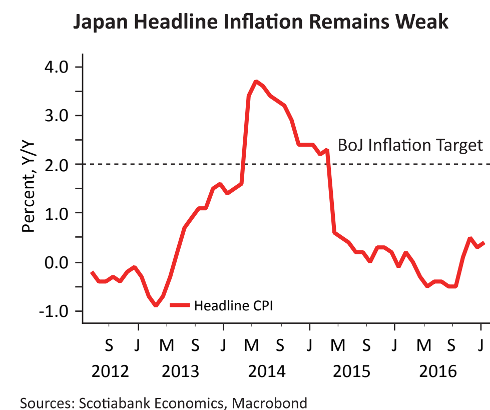


Chart 2



In the UK, divorce proceedings with the EU are underway; uncertainties regarding the implications of the UK's exit from the EU for financial services and the economy more broadly are significant. Higher domestic prices resulting from the drop in the GBP are liable to check consumer demand and keep growth subdued at the same time. We expect BoE policy settings to remain accommodative, despite the rise in measured inflation. Other indicators (wages growth) reflect weak inflationary impulses.

In Japan, meanwhile, the central bank is no nearer its 2% inflation target now than a year ago despite deploying aggressive monetary stimulus and, more recently, explicitly targeting the yield curve. Japan remains one of the weakest performing major economies. Absent any significant and sustained progress toward the Bank of Japan's inflation goal, we expect Japanese policy makers to continue to pursue extra-ordinary measures which will serve to weaken the JPY.

LATAM FX has had a fairly strong start of the year, benefiting from a broad-based USD decline, as well as improved sentiment about the outlook for the region, particularly for Mexico in light of the change of government in the US. Since Inauguration Day, all major LATAM FX is up around +2.5%, outside of CLP (-0.8%), and MXN (+16%), which is surging in light of an apparent softening of the stance of the new US administration towards the country.

Going forward, focus shifts to local political calendars, as elections increasingly taking centre stage. In Chile, the November 19th general election will see a change in government, as President Bachelet cannot run in the upcoming election. The contenders have not yet been defined as we are still in the primaries but, based on recent polls, it looks likely that a market-friendly candidate will be selected. In addition, even though Brazil's and Mexico's presidential elections are not set to take place until 2018, focus on them should start increasing over the coming months.

In Brazil, talk that former president Lula may attempt a comeback remains a subject of speculation, and political focus on elections could complicate Temer's reform agenda approval—which may weigh on the BRL. In Mexico, recent polls put Andres Manuel Lopez Obrador as the man to beat, and it's likely that as the June elections in the State of Mexico approach (the most populous in the country), market's focus on politics will rise. In addition, the NAFTA update negotiations are expected to kick off at some point this summer, which could lead to increased volatility for MXN.

In comparison, Peru and Colombia look set to be quieter, but in Colombia we still have questions about external accounts and public finance consolidation, while in Peru there is mounting debate on how flooding and the hit to infrastructure spending execution from the internationalization of Lava-Jato will hurt growth. The Peruvian government had already estimated a 1 percentage point hit to growth, even before the damage caused by tragic flooding. After a calm start to the year, the mid-year period may get bumpier for LATAM FX.

Asian EM FX, particularly the Chinese yuan (CNY), the Korean won (KRW) and the Taiwanese dollar (TWD), will remain resilient before US Treasury Department releases its regular FX report in April. Moreover, the failure of the Republican health care bill has called into question the Trump team's ability to push through other reforms. The Trump-Xi Summit reportedly set for 6–7 April will help balance competition and cooperation in US-China relations, in addition to the annual US-China Strategic and Economic Dialogue (SED) due mid-2017.

The USD is likely to advance against Asian EM FX from late April to May on account of either hawkish Fed comments aimed at talking up the chance of a June rate hike or potential flight-to-quality demand arising from the French presidential election on 23 April and 7 May or the Brexit process. The market hasn't fully factored in a second 25 bp rate increase in June. Post June FOMC meeting, the USD will likely pare some gains unless the Fed delivers a hawkish rate hike at its June gathering.

While USD/CNY is expected to reach 7.00 as at end-June thanks to China's tightened capital controls, we are still bullish on the Indian Rupee (INR) in the medium-term on hopes for more reforms. We see INR outperforming relative to the low-yielding Singapore Dollar (SGD) and TWD. The KRW, TWD and SGD are the most vulnerable currencies to the Fed's tightening in our view.

The Monetary Authority of Singapore is anticipated to stay on hold when releasing its semiannual monetary policy statement no later than 14 April. Korea is scheduled to hold the 19th presidential election on 9 May, dissipating domestic political uncertainty amid lingering geopolitical tensions on the Peninsula. Meanwhile, we remain bullish on Indonesian rupiah (IDR) due to high foreign ownership of local government bonds. The Thai baht (THB) will trade along with regional peers but may outperform some of them given the nation's rising current account surplus. The Malaysian Ringgit (MYR) will likely trade in a range of 4.40–4.50.

APPENDIX 1

International	2000–15	2016e	2017f	2018f	2000–15	2016e	2017f	2018f
	Real GDP (annual % change)				Consumer Prices (y/y % change, year-end)			
World (based on purchasing power parity)	3.9	3.1	3.4	3.5				
Canada	2.2	1.4	2.3	2.0	1.9	1.4	2.1	2.1
United States	1.9	1.6	2.3	2.4	2.2	1.8	2.4	2.3
Mexico	2.4	2.3	1.4	2.1	4.5	3.4	5.9	4.3
United Kingdom	1.8	1.8	2.0	1.2	2.2	0.7	2.7	2.4
Euro zone	1.2	1.6	1.7	1.7	1.9	1.1	1.4	1.7
Germany	1.2	1.7	1.8	1.7	1.6	1.7	1.5	1.8
France	1.3	1.2	1.4	1.6	1.7	0.6	1.3	1.4
Russia	4.6	-0.2	1.2	1.4	11.4	5.4	5.5	5.0
China	9.8	6.7	6.4	6.0	2.4	2.1	2.2	2.5
India	7.0	7.6	7.5	7.8	7.2	3.4	5.5	5.7
Japan	0.9	1.0	1.1	0.7	0.0	0.3	0.8	1.1
South Korea	4.4	2.8	2.5	2.6	2.8	1.3	2.1	2.3
Indonesia	5.6	5.0	5.3	5.5	6.2	3.0	4.9	4.7
Australia	3.0	2.5	2.5	2.6	2.9	1.5	2.0	2.1
Thailand	4.2	3.2	3.2	3.2	2.7	1.1	1.9	2.1
Brazil	3.4	-3.6	0.5	2.0	6.5	6.3	5.0	4.5
Colombia	4.3	2.0	2.1	3.2	5.0	5.7	4.5	3.5
Peru	5.3	3.9	2.9	3.7	2.7	3.2	3.1	2.8
Chile	4.3	1.6	1.8	2.4	3.3	2.7	2.8	3.2

Commodities	2000–15	2016e	2017f	2018f
	(annual average)			
WTI Oil (USD/bbl)	64	43	53	56
Brent Oil (USD/bbl)	67	45	56	59
Nymex Natural Gas (USD/mmbtu)	5.09	2.55	3.10	3.05
Copper (USD/lb)	2.36	2.21	2.50	2.65
Zinc (USD/lb)	0.81	0.95	1.35	1.55
Nickel (USD/lb)	7.45	4.36	5.00	5.50
Aluminium (USD/lb)	0.87	0.73	0.85	0.85
Iron Ore (USD/tonne)	68	58	65	55
Metallurgical Coal (USD/tonne)	127	115	170	130
Gold, London PM Fix (USD/oz)	845	1,251	1,200	1,250

APPENDIX 2

North America	2000–15	2016	2017f	2018f	2000–15	2016	2017f	2018f
	Canada (annual % change, unless noted)				United States (annual % change, unless noted)			
Real GDP	2.2	1.4	2.3	2.0	1.9	1.6	2.3	2.4
Consumer Spending	2.9	2.2	2.2	1.7	2.3	2.7	2.7	2.7
Residential Investment	3.8	2.8	1.1	-1.0	-0.7	4.9	3.8	2.7
Business Investment	2.7	-7.8	-1.1	3.0	2.4	-0.5	2.6	3.3
Government	2.2	1.9	2.0	2.0	1.0	0.8	0.9	1.1
Exports	1.3	1.1	2.3	3.7	3.8	0.4	2.3	2.8
Imports	3.1	-1.0	0.7	2.9	3.5	1.1	4.4	3.5
Nominal GDP	4.4	2.0	4.7	4.0	4.0	3.0	4.3	4.4
GDP Deflator	2.2	0.6	2.3	2.0	2.0	1.3	2.0	2.0
Consumer Price Index	2.0	1.4	2.1	2.0	2.2	1.3	2.4	2.4
Core CPI	1.8	1.9	1.7	1.9	2.0	2.2	2.3	2.3
Pre-Tax Corporate Profits	3.9	-4.5	11.0	5.0	5.9	-0.1	6.5	3.5
Employment	1.4	0.7	1.3	0.8	0.6	1.8	1.5	1.3
Unemployment Rate (%)	7.1	7.0	6.7	6.6	6.3	4.9	4.6	4.5
Current Account Balance (CAD, USD bn)	-13.9	-67.7	-45.6	-34.2	-521	-481	-472	-503
Merchandise Trade Balance (CAD, USD bn)	28.2	-25.9	-1.3	7.2	-668	-750	-820	-874
Federal Budget Balance (FY, CAD, USD bn)	-2.9	-1.0	-23.0	-28.5	-529	-587	-610	-650
per cent of GDP	-0.2	0.0	-1.1	-1.3	-3.8	-3.2	-3.2	-3.2
Housing Starts (000s, mn)	199	198	195	185	1.27	1.18	1.26	1.34
Motor Vehicle Sales (000s, mn)	1,639	1,949	1,940	1,925	15.4	17.5	17.8	17.9
Industrial Production	0.5	-0.3	2.5	1.7	0.8	-1.0	1.7	2.0
	Mexico (annual % change)							
Real GDP	2.4	2.3	1.4	2.1				
Consumer Price Index (year-end)	4.5	3.4	5.9	4.3				
Current Account Balance (USD bn)	-15.9	-27.9	-16.7	-21.2				
Merchandise Trade Balance (USD bn)	-6.8	-13.1	-0.5	-0.7				

Quarterly Forecasts	2016				2017				2018			
Canada	Q1	Q2	Q3	Q4	Q1e	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Real GDP (q/q ann. % change)	2.7	-1.2	3.8	2.6	2.8	2.0	2.1	2.1	2.0	2.0	1.9	1.9
Real GDP (y/y % change)	1.3	1.1	1.4	1.9	2.0	2.8	2.3	2.2	2.0	2.0	2.0	2.0
Consumer Prices (y/y % change)	1.5	1.6	1.2	1.4	2.0	2.1	2.3	2.1	1.9	1.9	2.1	2.1
Core CPI (y/y % change)	2.0	2.1	1.9	1.6	1.7	1.7	1.8	1.8	1.9	1.9	1.9	1.9
United States												
Real GDP (q/q ann. % change)	0.8	1.4	3.5	2.1	1.6	2.5	2.5	2.4	2.4	2.4	2.3	2.3
Real GDP (y/y % change)	1.6	1.3	1.7	2.0	2.2	2.4	2.2	2.3	2.5	2.4	2.4	2.3
Consumer Prices (y/y % change)	1.1	1.1	1.0	1.8	2.6	2.6	2.6	2.4	2.4	2.4	2.4	2.3
Core CPI (y/y % change)	2.2	2.2	2.2	2.2	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3

APPENDIX 3

Central Bank Rates	2016 Q3	2016 Q4	2017 Q1	2017 Q2f	2017 Q3f	2017 Q4f	2018 Q1f	2018 Q2f	2018 Q3f	2018 Q4f
Americas					(%, end of period)					
Bank of Canada	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.75	0.75	1.00
U.S. Federal Reserve	0.50	0.75	1.00	1.25	1.25	1.50	1.50	1.75	1.75	2.00
Bank of Mexico	4.75	5.75	6.50	6.75	7.00	7.25	7.50	7.50	7.50	7.50
Central Bank of Brazil	14.25	13.75	12.25	11.25	10.50	10.00	9.75	9.50	9.50	9.00
Bank of the Republic of Colombia	7.75	7.50	7.00	6.75	6.50	6.25	6.00	6.00	6.00	6.00
Central Reserve Bank of Peru	4.25	4.25	4.25	4.00	4.00	4.00	3.75	3.75	3.75	3.75
Central Bank of Chile	3.50	3.50	3.00	2.75	2.75	2.75	3.00	3.25	3.50	3.75
Europe										
European Central Bank	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Bank of England	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
Swiss National Bank	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75
Asia/Oceania										
Reserve Bank of Australia	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.75
Bank of Japan	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10
People's Bank of China	4.35	4.35	4.35	4.35	4.35	4.35	4.35	4.35	4.35	4.35
Reserve Bank of India	6.50	6.25	6.25	6.25	6.25	6.25	6.25	6.25	6.25	6.25
Bank of Korea	1.25	1.25	1.25	1.25	1.25	1.25	1.25	1.50	1.50	1.75
Bank Indonesia	5.00	4.75	4.75	4.75	4.75	4.75	4.75	5.00	5.00	5.25
Bank of Thailand	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.75	1.75	2.00
Currencies & Interest Rates										
Americas					(end of period)					
Canadian Dollar (USDCAD)	1.31	1.34	1.33	1.40	1.38	1.36	1.36	1.34	1.32	1.30
Canadian Dollar (CADUSD)	0.76	0.74	0.75	0.71	0.72	0.74	0.74	0.75	0.76	0.77
Mexican Peso (USDMXN)	19.39	20.73	18.72	20.11	20.61	21.27	21.49	21.32	21.39	21.68
Brazilian Real (USDBRL)	3.26	3.26	3.12	3.25	3.30	3.40	3.45	3.50	3.55	3.60
Colombian Peso (USDCOP)	2882	3002	2874	3100	3125	3100	3125	3150	3100	3125
Peruvian Nuevo Sol (USDPEN)	3.38	3.36	3.25	3.27	3.26	3.25	3.23	3.22	3.20	3.19
Chilean Peso (USDCLP)	657	670	660	649	653	658	655	652	649	647
Europe										
Euro (EURUSD)	1.12	1.05	1.07	1.02	1.05	1.10	1.12	1.12	1.15	1.15
U.K. Pound (GBPUSD)	1.30	1.23	1.26	1.20	1.25	1.25	1.30	1.30	1.35	1.35
Swiss Franc (USDCHF)	0.97	1.02	1.00	1.09	1.07	1.02	1.00	1.00	0.97	0.98
Swedish Krona (USDSEK)	8.58	9.10	8.97	8.90	8.80	8.70	8.60	8.50	8.40	8.30
Norwegian Krone (USDNOK)	7.98	8.64	8.60	8.20	8.00	8.00	7.80	7.60	7.40	7.20
Russian Ruble (USDRUB)	62.9	61.5	56.2	60.0	60.5	60.5	60.0	59.0	58.0	57.0
Asia/Oceania										
Japanese Yen (USDJPY)	101	117	111	115	117	117	121	121	122	122
Australian Dollar (AUDUSD)	0.77	0.72	0.76	0.76	0.75	0.75	0.75	0.75	0.78	0.78
Chinese Yuan (USDCNY)	6.67	6.95	6.89	7.00	7.00	7.10	7.05	7.00	7.00	6.95
Indian Rupee (USDINR)	66.6	67.9	64.9	66.5	66.5	68.0	67.5	67.0	67.0	66.5
South Korean Won (USDKRW)	1101	1208	1118	1160	1160	1200	1180	1170	1170	1160
Indonesian Rupiah (USDIDR)	13042	13473	13326	13500	13500	13600	13500	13400	13400	13300
Thai Baht (USDTHB)	34.6	35.8	34.4	35.2	35.2	36.0	35.8	35.4	35.4	35.0
Canada (Yields, %)										
3-month T-bill	0.53	0.46	0.55	0.50	0.50	0.50	0.60	0.80	0.90	1.10
2-year Canada	0.52	0.75	0.75	0.85	0.95	1.05	1.20	1.35	1.45	1.60
5-year Canada	0.62	1.11	1.12	1.25	1.35	1.40	1.50	1.65	1.80	1.90
10-year Canada	1.00	1.72	1.63	1.75	1.85	1.90	1.95	2.10	2.20	2.35
30-year Canada	1.66	2.31	2.30	2.35	2.45	2.50	2.55	2.65	2.75	2.80
United States (Yields, %)										
3-month T-bill	0.27	0.50	0.75	1.00	1.05	1.25	1.30	1.55	1.60	1.80
2-year Treasury	0.76	1.19	1.25	1.40	1.50	1.70	1.75	1.90	1.95	2.10
5-year Treasury	1.15	1.93	1.92	2.05	2.20	2.30	2.40	2.50	2.55	2.60
10-year Treasury	1.59	2.44	2.39	2.55	2.70	2.80	2.85	2.90	2.95	3.00
30-year Treasury	2.31	3.07	3.01	3.05	3.20	3.30	3.35	3.40	3.45	3.50

This report has been prepared by Scotiabank Economics as a resource for the clients of Scotiabank. Opinions, estimates and projections contained herein are our own as of the date hereof and are subject to change without notice. The information and opinions contained herein have been compiled or arrived at from sources believed reliable but no representation or warranty, express or implied, is made as to their accuracy or completeness. Neither Scotiabank nor any of its officers, directors, partners, employees or affiliates accepts any liability whatsoever for any direct or consequential loss arising from any use of this report or its contents.

These reports are provided to you for informational purposes only. This report is not, and is not constructed as, an offer to sell or solicitation of any offer to buy any financial instrument, nor shall this report be construed as an opinion as to whether you should enter into any swap or trading strategy involving a swap or any other transaction. The information contained in this report is not intended to be, and does not constitute, a recommendation of a swap or trading strategy involving a swap within the meaning of U.S. Commodity Futures Trading Commission Regulation 23.434 and Appendix A thereto. This material is not intended to be individually tailored to your needs or characteristics and should not be viewed as a "call to action" or suggestion that you enter into a swap or trading strategy involving a swap or any other transaction. Scotiabank may engage in transactions in a manner inconsistent with the views discussed this report and may have positions, or be in the process of acquiring or disposing of positions, referred to in this report.

Scotiabank, its affiliates and any of their respective officers, directors and employees may from time to time take positions in currencies, act as managers, co-managers or underwriters of a public offering or act as principals or agents, deal in, own or act as market makers or advisors, brokers or commercial and/or investment bankers in relation to securities or related derivatives. As a result of these actions, Scotiabank may receive remuneration. All Scotiabank products and services are subject to the terms of applicable agreements and local regulations. Officers, directors and employees of Scotiabank and its affiliates may serve as directors of corporations.

Any securities discussed in this report may not be suitable for all investors. Scotiabank recommends that investors independently evaluate any issuer and security discussed in this report, and consult with any advisors they deem necessary prior to making any investment.

This report and all information, opinions and conclusions contained in it are protected by copyright. This information may not be reproduced without the prior express written consent of Scotiabank.

™ Trademark of The Bank of Nova Scotia. Used under license, where applicable.

Scotiabank, together with "Global Banking and Markets", is a marketing name for the global corporate and investment banking and capital markets businesses of The Bank of Nova Scotia and certain of its affiliates in the countries where they operate, including, Scotiabanc Inc.; Citadel Hill Advisors L.L.C.; The Bank of Nova Scotia Trust Company of New York; Scotiabank Europe plc; Scotiabank (Ireland) Limited; Scotiabank Inverlat S.A., Institución de Banca Múltiple, Scotia Inverlat Casa de Bolsa S.A. de C.V., Scotia Inverlat Derivados S.A. de C.V. – all members of the Scotiabank group and authorized users of the Scotiabank mark. The Bank of Nova Scotia is incorporated in Canada with limited liability and is authorised and regulated by the Office of the Superintendent of Financial Institutions Canada. The Bank of Nova Scotia is authorised by the UK Prudential Regulation Authority and is subject to regulation by the UK Financial Conduct Authority and limited regulation by the UK Prudential Regulation Authority. Details about the extent of The Bank of Nova Scotia's regulation by the UK Prudential Regulation Authority are available from us on request. Scotiabank Europe plc is authorised by the UK Prudential Regulation Authority and regulated by the UK Financial Conduct Authority and the UK Prudential Regulation Authority.

Scotiabank Inverlat, S.A., Scotia Inverlat Casa de Bolsa, S.A. de C.V., and Scotia Derivados, S.A. de C.V., are each authorized and regulated by the Mexican financial authorities.

Not all products and services are offered in all jurisdictions. Services described are available in jurisdictions where permitted by law.

Fixed Income Strategy (London, Paris)

www.gbm.scotiabank.com

© 2016, The Bank of Nova Scotia

This material, its content, or any copy of it, may not be altered in any way, transmitted to, copied or distributed to any other party without the prior express written consent of Scotiabank™. This material has not been prepared by a member of the research department of Scotiabank, it is solely for the use of sophisticated institutional investors, and this material does not constitute investment advice or any personal recommendation to invest in a financial instrument or "investment research" as defined by the UK Prudential Regulation Authority or UK Financial Conduct Authority. This material is provided for information and discussion purposes only. An investment decision should not be made solely on the basis of the contents of this publication. It is not to be construed as a solicitation or an offer to buy or sell any financial instruments and has no regard to the specific investment objectives, financial situation or particular needs of any recipient. It is not intended to provide legal, tax, accounting or other advice and recipients should obtain specific professional advice from their own legal, tax, accounting or other appropriate professional advisers before embarking on any course of action. The information in this material is based on publicly available information and although it has been compiled or obtained from sources believed to be reliable, such information has not been independently verified and no guarantee, representation or warranty, express or implied, is made as to its accuracy, completeness or correctness. Information included in this material related to comparison performance (whether past or future) or simulated performance (whether past or future) is not a reliable indicator of future returns.

This material is not directed to or intended for use by any person resident or located in any country where the distribution of such information is contrary to the laws of such country. Scotiabank, its directors, officers, employees or clients may currently or from time to time own or hold interests in long or short positions in any securities referred to herein, and may at any time make purchases or sales of these securities as principal or agent. Scotiabank may also have provided or may provide investment banking, capital markets or other services to the companies referred to in this communication.

™ Trademark of The Bank of Nova Scotia. Used under license, where applicable. The bank of Nova Scotia is authorised and regulated by the Office of the Superintendent of Financial Institutions Canada. Scotiabank, together with "Global Banking and Markets", is a marketing name for the global corporate and investment banking and capital markets businesses of The Bank of Nova Scotia and certain of its affiliates in the countries where they operate, including Scotia Capital Inc., Scotia Capital (USA) Inc., Scotiabanc Inc.; Citadel Hill Advisors L.L.C.; The Bank of Nova Scotia Trust Company of New York; Scotiabank Europe plc; Scotiabank (Ireland) Limited; Scotiabank Inverlat S.A., Institución de Banca Múltiple, Scotia Inverlat Casa de Bolsa S.A. de C.V., Scotia Inverlat Derivados S.A. de C.V. – all members of the Scotiabank Group and authorized users of the mark. The Bank of Nova Scotia is incorporated in Canada with limited liability. Scotia Capital Inc. is a member of CIPF. Scotia Capital (USA) Inc. is a registered broker-dealer with the SEC and is a member of the NASD and SIPC. The Bank of Nova Scotia, Scotia Capital Inc. and Scotiabank Europe plc are authorised by the UK Prudential Regulation Authority. The Bank of Nova Scotia and Scotia Capital Inc. are subject to regulation by the UK Financial Conduct Authority and limited regulation by the UK Prudential Regulation Authority. Scotiabank Europe plc is authorised by the UK Prudential Regulation Authority and regulated by the UK Financial Conduct Authority and the UK Prudential Regulation Authority. Details about the extent of The Bank of Nova Scotia and Scotia Capital Inc.'s regulation by the UK Prudential Regulation Authority are available from us on request. Scotiabank Inverlat, S.A., Scotia Inverlat Casa de Bolsa, S.A. de C.V., and Scotia Derivados, S.A. de C.V., are each authorized and regulated by the Mexican financial authorities.

Foreign Exchange Strategy

This publication has been prepared by The Bank of Nova Scotia (Scotiabank) for informational and marketing purposes only. Opinions, estimates and projections contained herein are our own as of the date hereof and are subject to change without notice. The information and opinions contained herein have been compiled or arrived at from sources believed reliable, but no representation or warranty, express or implied, is made as to their accuracy or completeness and neither the information nor the forecast shall be taken as a representation for which Scotiabank, its affiliates or any of their employees incur any responsibility. Neither Scotiabank nor its affiliates accept any liability whatsoever for any loss arising from any use of this information. This publication is not, and is not constructed as, an offer to sell or solicitation of any offer to buy any of the currencies referred to herein, nor shall this publication be construed as an opinion as to whether you should enter into any swap or trading strategy involving a swap or any other transaction. The general transaction, financial, educational and market information contained herein is not intended to be, and does not constitute, a recommendation of a swap or trading strategy involving a swap within the meaning of U.S. Commodity Futures Trading Commission Regulation 23.434 and Appendix A thereto. This material is not intended to be individually tailored to your needs or characteristics and should not be viewed as a "call to action" or suggestion that you enter into a swap or trading strategy involving a swap or any other transaction. You should note that the manner in which you implement any of the strategies set out in this publication may expose you to significant risk and you should carefully consider your ability to bear such risks through consultation with your own independent financial, legal, accounting, tax and other professional advisors. Scotiabank, its affiliates and/or their respective officers, directors or employees may from time to time take positions in the currencies mentioned herein as principal or agent, and may have received remuneration as financial advisor and/or underwriter for certain of the corporations mentioned herein. Directors, officers or employees of Scotiabank and its affiliates may serve as directors of corporations referred to herein. All Scotiabank products and services are subject to the terms of applicable agreements and local regulations. This publication and all information, opinions and conclusions contained in it are protected by copyright. This information may not be reproduced in whole or in part, or referred to in any manner whatsoever nor may the information, opinions and conclusions contained in it be referred to without the prior express written consent of Scotiabank.

™ Trademark of The Bank of Nova Scotia. Used under license, where applicable. Scotiabank, together with "Global Banking and Markets", is a marketing name for the global corporate and investment banking and capital markets businesses of The Bank of Nova Scotia and certain of its affiliates in the countries where they operate, all members of the Scotiabank group and authorized users of the mark. The Bank of Nova Scotia is incorporated in Canada with limited liability and is authorised and regulated by the Office of the Superintendent of Financial Institutions Canada. The Bank of Nova Scotia and Scotiabank Europe plc are authorised by the UK Prudential Regulation Authority. The Bank of Nova Scotia is subject to regulation by the UK Financial Conduct Authority and limited regulation by the UK Prudential Regulation Authority. Scotiabank Europe plc is authorised by the UK Prudential Regulation Authority and regulated by the UK Financial Conduct Authority and the UK Prudential Regulation Authority. Details about the extent of The Bank of Nova Scotia's regulation by the UK Prudential Regulation Authority are available on request. Scotiabank Inverlat, S.A., Scotia Inverlat Casa de Bolsa, S.A. de C.V., and Scotia Inverlat Derivados, S.A. de C.V., are each authorized and regulated by the Mexican financial authorities.Not all products and services are offered in all jurisdictions. Services described are available in jurisdictions where permitted by law.