Firing on More Cylinders

- **Sources of global growth are strengthening and diversifying, both within countries and across regions.**
- **The strength of demand is leading to a re-assessment of monetary policy prospects in a number of countries, with the possibility that additional central banks will soon follow the US Fed's lead by beginning to withdraw exceptional stimulus.**

Global momentum remains strong, despite occasionally weak data in some countries (chart 1 and table 1). Growth is so solid, in fact, that the market's focus is now on determining which central banks will follow the Federal Reserve and tighten interest rates next: the Bank of Canada is nearly certain to move, followed potentially by the Bank of England and ECB. The withdrawal of monetary stimulus, when it occurs, is likely to be of material consequence to financial markets. We have already seen sharp movements in currencies and bond markets in the countries where central bankers have adopted more hawkish language. While there is, of course, the possibility of increased volatility as markets digest the potential for reduced central bank support, we consider this shift in stance from central bankers to be very good news: it signals that the economic recovery is now, at long last, self-sustaining, and far less reliant on exceptional policy support.

Other threats to the outlook are mixed. It now appears clear that the United States (US) will seek to modernize NAFTA instead of ripping it up. The US is, however, now also considering tariffs on imported steel by applying a national security designation to the sector. If enacted, these tariffs would have the potential to trigger significant retaliatory actions that could develop into a trade war. Political developments also loom large in Latin America and concerns about conflict in the Korean Peninsula remain heightened. Economic risks are, meanwhile, diminishing as the increasingly broad-based nature of activity in most advanced economies reduces the reliance on households and policy support to drive growth.

In **Canada**, GDP growth stormed ahead to an unexpectedly quick pace of 3.7% q/q in Q1. Economic activity continued to be led in a lopsided fashion by consumer demand and residential investment, but Q1 also provided some tentative evidence of a strong pick-up in business investment. This incipient broadening of the sources of private-sector growth at the same time as public infrastructure spending is set to move ahead underpins another mark-up in our growth projections for 2017 to 2.7%, roughly double the Bank of Canada's estimate of Canada's potential. If realized, this would be the highest annual growth rate since 2011's 3.1% and it would make Canada one of the fastest-growing countries in the industrialized world. Some of this demand is likely being pulled ahead from future periods and we anticipate a marked deceleration next year: we have shaved our projection for 2018 growth from 2.0% to 1.9%, which reflects our expectation that Canadian economic activity will continue its shift to a more durable mix of sources in the years ahead. The strength of demand, as well as much more positive commentary from the Bank of Canada on the state of the economy, lead us to believe that the Bank of Canada will raise interest rates by 25bps on July 12, followed by other increases in the fourth quarter of the year and the first of next year.

CONTACTS

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

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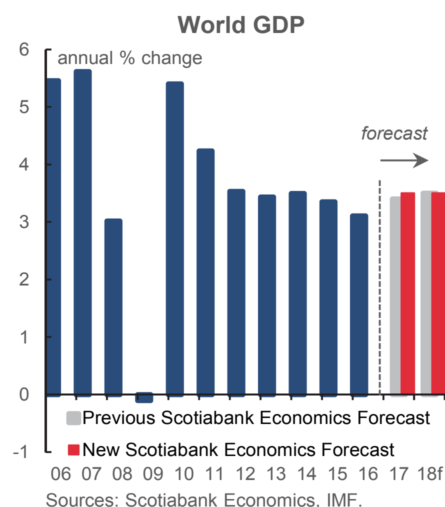
Chart 1



Sources: Scotiabank Economics, IMF.

As the **US** economy heads into the eighth year of what is now its third-longest expansion, the fundamentals for continued solid growth remain in place, though any slack in the economy is rapidly closing with the economy at full employment. Our outlook is changed only modestly from three months ago. We have removed nearly all of the very limited additional fiscal stimulus that we had programmed in 2017 and 2018 based on our current expectation that virtually no meaningful tax reform or expanded infrastructure spending is likely to be implemented by the US federal government over the next 18 months. At the same time, a variety of material risks to the US outlook have abated: the USD has weakened, bond yields are lower for longer than expected, financial conditions have materially eased, oil prices are lower than previously projected, and trade policy risks are proving to be more bark than bite, thereby generating less of a drag than expected on investment. Taking all of these factors into account, our projections for US growth have been shaved only slightly from our last *Global Outlook*, down from 2.3% to 2.2% in 2017, and from 2.4% to 2.2% in 2018. Growth continues to be driven by support from a strong labour market, rising consumption, recovering capex, and a slightly better external picture, all of which should compensate for a relatively soft Q1. Owing to the still strong recovery, and what we perceive to be a hawkish bias at the Fed, we project one more rate rise this year in December followed by two more in 2018.

In **Latin America**, economic performance is likely to be heavily affected by politics. In **Mexico**, progress on the NAFTA negotiations and the 2018 elections will together have a disproportionate impact on economic developments. The country has opened up important investment opportunities through structural reforms, but if the President elected in July 2018 does not plan to follow through on them then important opportunities could be lost and growth would suffer. In **Chile**, we have seen a material slowdown in the economy in the aftermath of the copper price correction, but some of the drag has been domestically generated. The country also saw investment decline owing to cost inflation, partially driven by regulation, a tax reform that increased corporate taxes by 25%, and the elimination of some tax breaks that previously shielded investments. With the presidential election scheduled for November 2017, we could see both positive and negative changes to the country's growth outlook: major electoral platforms remain in flux. In **Colombia**, presidential elections are scheduled for May 2018, and although it's still not clear who the candidates will be, it's possible that the vote could have implications for the peace efforts between the government and the guerrillas, as well as broader effects on policy. In **Peru,** the government's position in the legislature is very weak, which has made reform difficult and even complicated the more basic administration of government and the execution of infrastructure projects. If the government cannot change the country's political dynamics, whether through a cabinet reshuffle or another strategy, economic growth is likely to slow owing to weak execution of public spending and low private-sector confidence. In **Brazil**, the fate of the current government's reform campaign, including revisions to the pension system, will determine whether the country is able to maintain investor confidence in both its public debt and in new investments in real assets. Brazilian balance sheets, both in the public and private sectors, remain stretched, so maintaining foreign support is important if the economic rebound is to gain steam.

In the **Eurozone**, survey indicators are extremely strong; they imply that GDP growth should continue to accelerate throughout 2017. On paper, the relationship between output and survey indicators suggests that GDP growth could, by the end of the year, approach 1% q/q with the annual rate accelerating towards 3% y/y. In turn, this would translate into an annual average growth rate of 2.25 to 2.5%. Yet, both the consensus and the ECB expect growth of 2% y/y or lower. This cautious outlook may reflect scepticism that the elevated survey readings will actually filter through into the hard activity data, particularly in the context of the stop-start nature of the eurozone recovery thus far. We are more glass-half-full

Table 1 — Global Real GDP

	2000–15	2016	2017f	2018f
		(annual % change)		
World (PPP)	3.9	3.1	3.5	3.5
Canada	2.2	1.5	2.7	1.9
United States	1.9	1.6	2.2	2.2
Mexico	2.4	2.3	2.0	2.5
United Kingdom	1.8	1.8	1.6	1.2
Euro zone	1.2	1.6	2.2	2.0
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	6.6	6.1
India	7.0	7.6	7.1	7.6
Japan	0.9	1.0	1.2	0.8
South Korea	4.4	2.8	2.8	2.7
Indonesia	5.6	5.0	5.3	5.5
Australia	3.0	2.5	2.4	2.7
Thailand	4.2	3.2	3.2	3.2
Brazil	3.4	-3.6	0.3	2.5
Colombia	4.3	2.0	1.9	2.2
Peru	5.3	3.9	2.5	3.7
Chile	4.3	1.6	1.6	2.6

and forecast an annual average growth rate of 2.2% y/y, twice the growth of potential output, marking an extremely strong performance for the currency area.

The outlook for the **UK** has softened since earlier in the year. In particular, Q1 GDP was much weaker than expected (at just 0.2% q/q) and forward-looking indicators imply that growth is unlikely to be any better over the remainder of the year. Indeed, the factors that caused GDP growth to slow by so much during Q1 are intensifying, which implies that the headwinds to growth will build as the year progresses.

China's economy is showing early signs that growth is decelerating again after a period of stimulus-induced strength. Over the past few quarters, economic activity has been underpinned by massive public outlays in fixed assets, particularly in infrastructure. The slowdown is becoming evident in the industrial sector, as implied by somewhat softer data on high-frequency indicators such as steel output, electricity production, and business confidence. We expect that the Chinese government will continue its sizeable fiscal injections to keep the economy's growth trajectory in line with requirements for social harmony. China is well positioned to meet the official growth target of "around 6.5%" in 2017; we expect output to expand by 6.6% this year. In 2018, the economy will likely continue its transition toward a more sustainable growth trajectory, with real GDP expected to advance by 6.1% y/y.

Canada

- **Canadian economic growth continues to rely heavily on consumption and housing activity, but we—finally—see early signs that the sources of this growth are beginning to broaden to include contributions from business investment.**
- **Following a robust Q1, real GDP growth in 2017 is projected to hit 2.7%, well above the 2.0% we foresaw at the beginning of the year. Some of this demand is likely being pulled ahead from 2018 and we expect growth to slow to 1.9% next year as activity pivots to more balanced and sustainable contributions from investment and trade, as well as increased public infrastructure spending.**
- **We remain sanguine about the likely impact on Canadian economic activity of trade policy uncertainties emanating from the US despite the occasionally overheated rhetoric coming from Washington.**

GREEN SHOOTS OF BROADENING GROWTH

Canadian GDP stormed ahead to an unexpectedly quick pace of 3.7% q/q in Q1. Economic activity continued to be led in a lopsided fashion by consumer demand and residential investment, but Q1 also provided some tentative evidence of a strong pick-up in business investment. This incipient broadening of the sources of private-sector growth at the same time as public infrastructure spending is set to move ahead underpins another mark-up in our growth projections for 2017 to 2.7%, roughly double the Bank of Canada's estimate of Canada's potential. If realized, this would be the highest annual growth rate since 2011's 3.1% and it would make Canada one of the fastest-growing countries in the industrialized world. Some of this demand is likely being pulled ahead from future periods and we anticipate a marked deceleration next year: we have shaved our projection for 2018 growth from 2.0% to 1.9% reflecting our expectation that Canadian economic activity will continue its shift to a more durable mix of sources in the years ahead.

A STILL BULLISH CONSUMER

Domestic growth remains heavily—too heavily—dependent on households: real consumer spending and residential investment growth clocked in at a more than 5% annualized rate in the first three months of the year, the strongest quarterly performance in almost a decade. The two sectors combined now account for a record 66% share of GDP (chart 1). Yet, at the same time, the sources of Canada's growth are starting to diversify: in April our diffusion index on the components of Canadian GDP reached its highest level since 2013 (chart 2)

Confidence, incomes, and spending are being buoyed by a robust labour market and historically low interest rates. Job gains this year have averaged almost 30,000 each month, the strongest pace of hiring in a decade (chart 3). The jobless rate is testing a cycle-low 6.6% (or just 5.5% when measured according to the US methodology that produces the current 4.3% unemployment rate south of the border), at the same time that the prime-age employment-to-population ratio is

CONTACTS

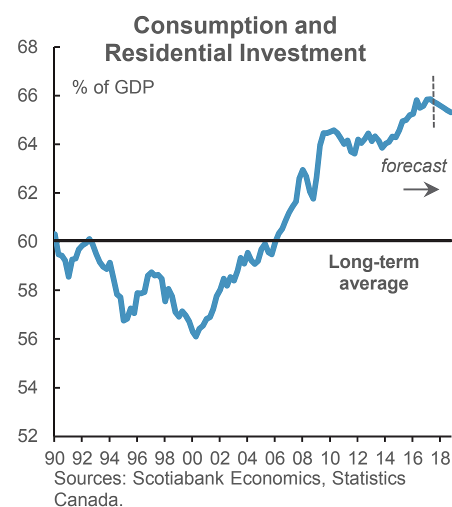
Brett House, VP & Deputy Chief Economist
416.863.7463
Scotiabank Economics
brett.house@scotiabank.com

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, Statistics Canada.

near all-time highs (chart 4). Recent job gains have been overwhelmingly dominated by full-time paid positions spread increasingly broadly across sectors and regions—a testament to improving business sentiment.

Wealth gains are providing additional support, especially in housing where the lack of interest deductibility provides an incentive for Canadians to pay down mortgages and build equity more quickly than their American counterparts. Surging home values have generated over CAD 300 bn in increased household net worth in the past year alone. Assuming a conservative housing wealth effect of 5 cents on the dollar, rising home equity is contributing upwards of a percentage point to the underlying trend in consumer spending. Big-ticket purchases are major beneficiaries, with motor-vehicle sales and expenditures on home renovations at record highs.

Retailers and hospitality services also are getting a boost from strong tourism demand as a relatively weak Canadian dollar attracts a growing number of tourists from abroad and dampens Canadian cross-border trips south of the border. Tourism spending in Canada, adjusted for inflation, increased 5% in the 12 months to 2017Q1, with rising outlays by both Canadian and international travelers.

Looking forward, consumer fundamentals are generally favourable. Consumer confidence and major purchase plans remain strong. Tightening labour market conditions are expected to lead to a pick-up in the currently moribund rate of wage growth. Some lower income households stand to get a hand-up in a few provinces from legislated increases in the minimum wage that should further buttress consumption.

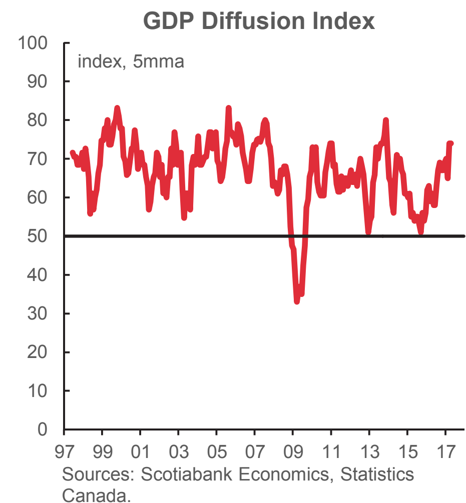
Even so, we continue to forecast a more moderate path for consumer spending as the stimulus from last year's rollout of the Canada Child Benefit fades and housing markets in Toronto and Vancouver become less of a one-way bet. Non-mortgage credit growth has recently slowed, an encouraging sign that households are taking a more cautious approach to taking on more credit given their already record levels of indebtedness. On average, we expect real consumer spending to track real income growth of around 2% in the latter half of 2017 and into next year.

RISING INTEREST RATES, BUT STRONG HOUSEHOLD BALANCE SHEETS

As the Bank of Canada moves to normalize its policy settings, moderately higher interest rates and bond yields pose another headwind to consumer demand growth. A 100 bps increase in the effective interest rate on household mortgage and non-mortgage debt, all else equal, would lift the Canada-wide aggregate household debt-service ratio from its current level of 14.2% of personal disposable income to around 16%—almost two standard deviations above the ratio's 26-year average. The effect would be even more extreme in Toronto and Vancouver, where average debt-service ratios are substantially higher. The additional cost to households to service their loans is likely to dent some discretionary spending.

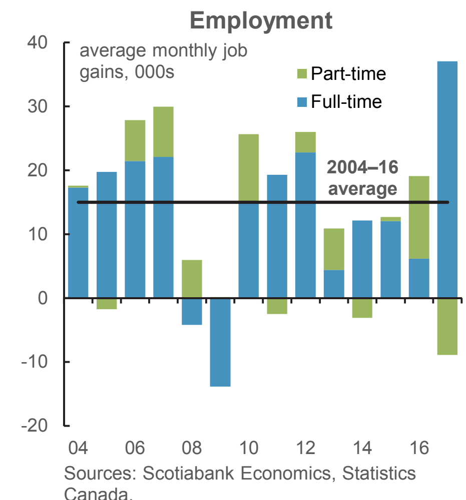
Overall, however, Canadian households have the capability to weather the gradual, though now more imminent, increases in interest rates we expect over our forecast horizon. Mortgage loans account for two-thirds of household credit market debt. The fixed-rate nature of the majority of these mortgages implies that

Chart 2



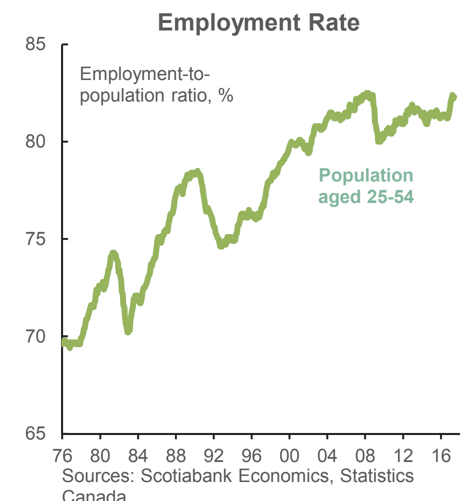
Sources: Scotiabank Economics, Statistics Canada.

Chart 3



Sources: Scotiabank Economics, Statistics Canada.

Chart 4



Sources: Scotiabank Economics, Statistics Canada.

they will be affected only gradually by higher market rates. Given elevated levels of home equity, particularly in areas where house prices have advanced most quickly, many households should be able to avail themselves of refinancing options, if necessary, to lower immediate cash-flow needs. The existing macroprudential requirement that borrowers must qualify for financing at the higher five-year posted mortgage rate has also baked in some financial cushion.

Other balance sheet measures suggest a lower level of financial vulnerability than is inferred from debt-service ratios alone. The household savings rate, at around 4.5%, is in line with its cycle average and could be brought down in response to liquidity needs. Household assets exceed liabilities by a ratio of six to one, providing another potential source of additional funds. Moreover, we anticipate that rising interest rates are likely to be at least partly matched by rising incomes.

HOUSING MARKETS SHOULD REMAIN SOLID

Housing demand remains strong and the chances of a correction remain limited in the face of still-constrained supply in both Vancouver and Toronto, and indications that excess demand is spilling over into other markets such as Calgary, Ottawa, and Montreal. Housing demand in Canada's major cities continues to receive support from high rates of international migration, intra- and inter-provincial migration, strong growth that is converging across Canada's provinces, foreign capital inflows, and still-low interest rates. The increase in rates we now expect from the Bank of Canada during 2017–18 won't meaningfully change this picture: housing starts are forecast to total about 200,000 units this year given the strength of permit demand and the relatively low level of unsold inventory. We already see that efforts to dampen high-end and foreign demand in BC's Lower Mainland appear to have had only a temporary effect, while it's too soon to assess if Ontario's Fair Housing Plan will durably weaken price momentum in Toronto's market without additional measures to increase supply. Overall, we still expect housing to add some 0.3 ppts to GDP growth this year, its largest contribution since 2012.

Low borrowing costs, robust job growth, and solid household formation reinforced by high immigration numbers should remain supportive of housing demand into 2018. Nevertheless, the combination of higher borrowing costs, macroprudential tightening, and strained affordability in Canada's highest-priced markets are expected to lead to some slowing in home sales and house price appreciation in the year ahead. As a result, we expect 2018 to mark the first year since 2009 in which residential investment provides a drag on growth.

MANUFACTURING REVIVAL DRIVING INCREASED INVESTMENT

Firmer demand in the United States—the destination for nearly 60% of overall Canadian manufacturing output—and in Canada lifted Canadian non-automotive manufacturing shipments 8% y/y through April. This represents the best performance in nearly seven years and is double the growth rate recorded from the start of the current economic expansion through mid-2014. We

Table 1 — Quarterly Canadian Forecasts

	2016				2017				2018			
	Q1	Q2	Q3	Q4	Q1	Q2e	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Economic												
Real GDP (q/q ann. % change)	2.8	-1.4	4.2	2.7	3.7	2.5	2.2	2.0	1.9	1.8	1.7	1.6
Real GDP (y/y % change)	1.3	1.1	1.5	2.0	2.3	3.3	2.8	2.6	2.2	2.0	1.8	1.8
Consumer prices (y/y % change)	1.5	1.6	1.2	1.4	1.9	1.5	1.7	1.7	1.7	1.9	2.1	2.1
CPI ex. food & energy (y/y % change)	1.7	2.0	2.0	1.8	2.0	1.5	1.5	1.6	1.7	1.7	1.9	1.9
Avg. of new core CPIs (y/y % change)	1.8	2.0	1.8	1.7	1.6	1.3	1.2	1.3	1.4	1.5	1.7	1.8
Financial												
Canadian Dollar (USDCAD)	1.30	1.29	1.31	1.34	1.33	1.30	1.30	1.28	1.28	1.27	1.25	1.25
Canadian Dollar (CADUSD)	0.77	0.77	0.76	0.74	0.75	0.77	0.77	0.78	0.78	0.79	0.80	0.80
Bank of Canada Overnight Rate (%)	0.50	0.50	0.50	0.50	0.50	0.50	0.75	1.00	1.25	1.25	1.25	1.25
3-month T-bill (%)	0.45	0.49	0.53	0.46	0.55	0.71	0.90	1.10	1.30	1.30	1.25	1.25
2-year Canada (%)	0.54	0.52	0.52	0.75	0.75	1.10	1.20	1.30	1.35	1.40	1.45	1.50
5-year Canada (%)	0.68	0.57	0.62	1.11	1.12	1.39	1.50	1.65	1.75	1.85	1.90	2.00
10-year Canada (%)	1.23	1.06	1.00	1.72	1.63	1.76	1.85	2.00	2.10	2.25	2.40	2.50
30-year Canada (%)	2.00	1.72	1.66	2.31	2.30	2.15	2.20	2.40	2.50	2.60	2.70	2.80

expect this solid performance to acquire additional momentum in the latter half of 2017, especially since order growth has accelerated to a double-digit year-over-year rate and is outpacing production gains (chart 5). The backlog of unfilled orders at Canadian plants is also at record highs for the current expansion, pointing to a continuation throughout 2017 of the strong industrial performance that has emerged so far this year. In fact, industrial activity has picked up significantly in Canada in recent months, and is now in the forefront of growth among G7 countries.

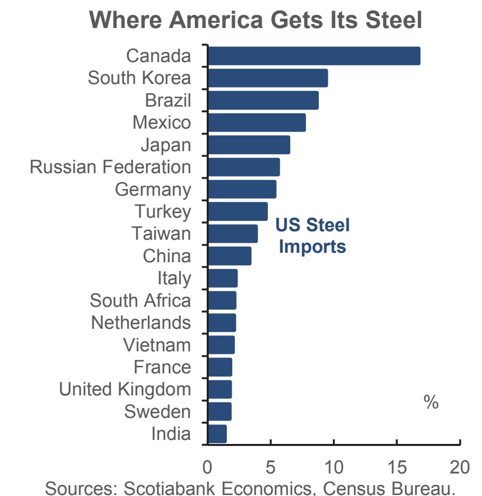
Historical evidence indicates that industrial orders in Canada tend to follow developments in the United States, but with greater volatility. However, looking at a historical series of the six-month moving average of Canadian manufacturing orders it becomes clear that major trend reversals in Canadian new orders occur around the same time as south of the border. This implies that continued solid gains in industrial activity are likely during the second half of 2017, especially since order growth is exceeding output gains in both countries (chart 5 again).

Machinery, computers, and electronic equipment are providing much of the boost to industrial activity in Canada. These sectors account for roughly 30% of overall manufacturing shipments and orders in these sectors have surged nearly 20% year-to-date compared with the same period in 2016. These sectors also have some of the highest export intensities in Canada's industrial sector and they have been operating at full capacity for some time. Economy-wide manufacturing capacity utilization increased by 1.5 ppts in the opening months of 2017, the largest advance over the same period in six years. This should lead to increased capital spending, typically with a two-quarter lag to exports gains in trade-focused sectors. The 13% jump in demand for industrial and metalworking machinery so far this year, the fastest pace since 2011, implies that this investment recovery has started to unfold. If fully realized, this investment would start to reverse the capex hiatus of recent years even as trade policy uncertainties remain unresolved.

Chart 5

Sources: Scotiabank Economics, Statistics Canada, US Census Bureau.

Chart 6



Sources: Scotiabank Economics, Census Bureau.

FISCAL: MORE SPENDING, BUT SMALLER DEFICITS

Across all levels of government, current and capital spending is still projected to contribute about 0.4 ppts to real GDP growth in calendar 2017 and 2018. With respect to Ottawa's forecast deficits for FY18 and FY19, we now expect Canada's real GDP and GDP price deflator to come in higher than the projections used in the federal Budget last March, building on stronger-than-anticipated federal revenues in fiscal 2016-17 (FY17). Consequently, federal deficits in FY18 and FY19 are now expected to average close to CAD 20 bn, excluding the government's CAD 3 bn adjustment for risk, which improves upon the CAD 25 bn shortfalls previously anticipated. This reinforces our expectation that the federal accumulated deficit, even with the risk adjustment included, should stabilize at just over 30% of GDP over the next two years.

While the mix of federal spending may shift with events, such as the compensatory measures recently announced for softwood lumber producers, the overall levels of spending are assumed to remain as programmed in the March federal budget. Infrastructure spending is picking up, but risks remain that it may continue to be delivered more slowly than planned, particularly for Phase 2 of the federal government's plan, which has always been expected to ramp up in FY19.

For the majority of Provinces, forecast surpluses or curtailed deficits should, by FY19, result in net debt increases that largely reflect stepped-up capital outlays rather than operating deficits.

EXTERNAL RISKS REMAIN, BUT APPEAR LESS ACUTE

We remain relatively sanguine about the risks facing Canada from changes in US trade policy. The 18 May letter from US Trade Representative Lighthizer to Congress informing of the US administration's intent to re-open NAFTA outlined a fairly benign set of

priorities for negotiations and gave further credence to our expectation that the agreement will be 'tweaked' and modernized, rather than revolutionized or ripped up. With formal talks set to begin in late-August, all three NAFTA member governments have launched consultative processes with their national stakeholders to identify their negotiating priorities. Incentives are broadly aligned to bring the talks to a smooth conclusion. Nevertheless, neither Canada nor Mexico face pressure to cut a deal at any price, and if negotiations are not concluded by the end of 2017, campaigning for the July 2018 Mexican Presidential elections would likely delay an end to the talks well into late-2018.

The concurrent dispute over softwood lumber should have limited impact on the Canadian macroeconomy—the sector accounts for only about 1% of Canadian GDP—but may have specific effects on individual producers and their communities. The US residential construction industry needs every Canadian log it can get. Absent a new Softwood Lumber Agreement that imposes quotas to cut Canada's roughly 30% share of the US market, the costs of the preliminary duties imposed by the US government on Canadian softwood imports should, in the main, fall on US consumers rather than Canada's exporters.

A trade probe against China and other exporters of low-cost steel into the US market that was launched in April by President Trump is due to deliver its findings any day now. The probe was justified on grounds of "national security", but the US's five largest suppliers of steel, which together account for nearly half of all US steel imports, are all American allies: Canada, South Korea, Brazil, Mexico, and Japan (chart 6). In contrast, China provides only about 3.5% of US steel imports, making it the 10th largest supplier to the US, in part because Chinese steel is already subject to a variety of penalties that have slowed trade. While Canada is the most exposed of any country to a US effort to impose tariffs or quotas on all steel imports, the likelihood of any such move is reduced by the inevitable backlash it would produce from several of the US's major allies.

Finally, we continue to see limited immediate risk to Canada from US tax reform. While it is entirely possible that a border adjustment tax will continue to feature in Congressional discussions, we see little chance that it will be enacted. There is a somewhat higher probability that some form of agreement on corporate tax cuts could be reached, which, combined with carbon pricing measures north of the border, could put Canada's businesses at a competitive disadvantage over the longer term.

Table 2 — Canada

	2000–15	2016	2017f	2018f
	(annual % change, unless noted)			
Real GDP	2.2	1.5	2.7	1.9
Consumer spending	2.9	2.3	3.0	1.8
Residential investment	3.8	3.0	3.6	-1.4
Business investment	2.7	-7.8	-0.3	3.2
Government	2.2	1.8	2.0	2.0
Exports	1.3	1.0	1.8	3.7
Imports	3.1	-0.9	2.1	2.7
Nominal GDP	4.4	2.1	5.2	3.9
GDP Deflator	2.2	0.6	2.4	2.0
Consumer price index (CPI)	2.0	1.4	1.7	1.9
CPI ex. food & energy	1.6	1.9	1.7	1.8
Pre-tax corporate profits	3.9	-4.5	25.0	5.0
Employment	1.4	0.7	1.5	0.9
Unemployment rate (%)	7.1	7.0	6.6	6.5
Current account balance (CAD bn)	-13.9	-67.0	-47.8	-37.4
Merchandise trade balance (CAD bn)	28.2	-26.0	0.0	7.5
Federal budget balance (FY, CAD bn)	-2.9	-1.0	-22.0	-24.5
percent of GDP	-0.2	0.0	-1.1	-1.1
Housing starts (000s)	199	198	202	190
Motor vehicle sales (000s)	1,639	1,949	2,000	1,980
Industrial production	0.5	-0.3	3.8	1.5
WTI oil (USD/bbl)	64	43	51	53
Nymex natural gas (USD/mmbtu)	5.09	2.55	3.10	2.95

The Provinces

SOLID REGIONAL EXPANSION SEA TO SEA

- **Output, employment, and incomes are revised higher across Canada for 2017, followed by more moderate gains in 2018.**
- **For the fiscal year just completed, a combined surplus for the seven net oil-consuming Provinces is expected for the first time since fiscal 2007–08 (FY08).**

Mirroring this year's stronger forecast expansion are y/y increases to date in private-sector paid employment in seven provinces, with full-time positions climbing in six jurisdictions. British Columbia is leading provincial private-sector job creation for the second consecutive year, followed by sizeable gains in central Canada, leading to stronger weekly wage growth for these provinces after their tepid 1.1% wage hike in 2016. Alberta, aided by post-wildfire reconstruction, and Saskatchewan are starting to recoup some of the 88,000 full-time positions lost from Q2 2015 to Q4 2016. In 2018. Annual unemployment rates in central Canada, Nova Scotia and PEI are expected to be lower than their 2007 rates entering the recession, even with the anticipated easing in job creation next year.

Aided by tourism, household income gains this spring are sustaining further healthy retail sales advances for the net oil-consuming provinces, alongside rebounding sales in Alberta and Saskatchewan (chart 1). Contributing to Newfoundland and Labrador's modest y/y sales growth to date this year is the erosion of higher-wage jobs as resource projects near completion. BC and Quebec stand out in 2017 for the relief provided in consumers' health care payments. In 2018, as the six smaller provinces adopt their customized versions of a pan-Canadian carbon price, and fees for public services increasingly reflect full-cost recovery, a greater squeeze is anticipated on the household income available for discretionary purchases.

As new residential construction cools over the next eighteen months despite an upswing in affordable housing expenditures, the planned step-up in infrastructure investment from provincial programmes plus the implementation of Phase 1 of the federal infrastructure plan are expected to provide an important offset. As well, oil & gas investment, whose share of total-industry capital spending was nearly halved to 15% last year, is beginning an extended recovery with an expected increase of over 10% in 2017. After the setback from the 2016 spring wildfires, an uptick in Western Canada's oil exports to the US this year is forecast that will underline the intensifying demand for additional pipeline capacity to markets (chart 2).

A sustained strengthening in non-energy investment through 2018 is forecast for the majority of provinces, partly in response to expansion in transportation and other activities serving goods-producers and the upswing in hospitality and arts with Canada's 150th celebration. Also critical is the significant digital and IT expansion in several regions and continuing demand for business support services.

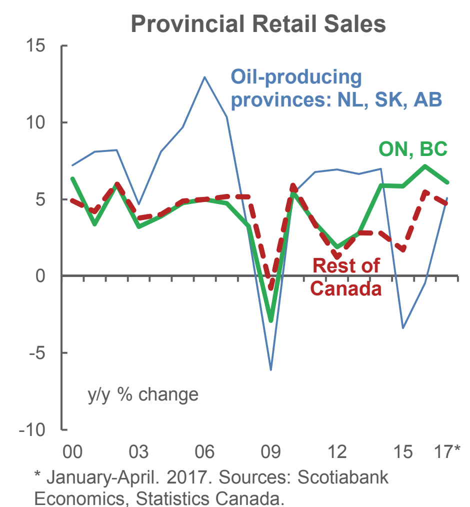
REGAINING BLACK INK

For FY17, British Columbia's larger-than-expected final surplus, the substantial black ink indicated by Quebec's monthly data, and Ontario's sizeable deficit reduction point to a combined positive balance of more than $2 billion for the seven

CONTACTS

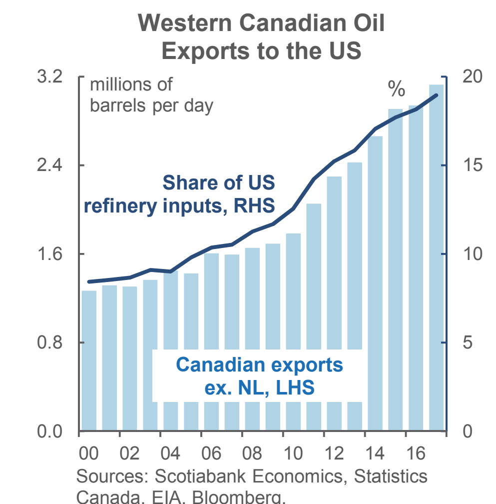
Mary Webb
416.866.4202
Scotiabank Economics
mary.webb@scotiabank.com

Chart 1



* January-April. 2017. Sources: Scotiabank Economics, Statistics Canada.

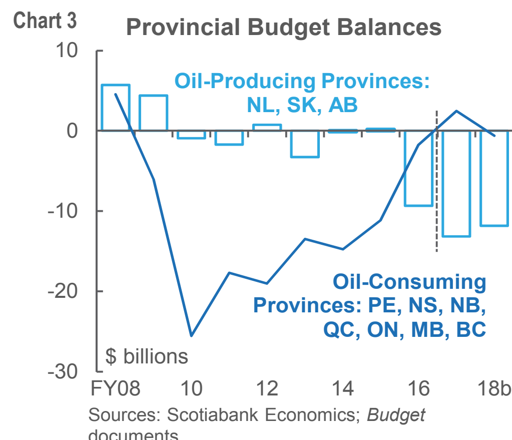
Chart 2



Sources: Scotiabank Economics, Statistics Canada, EIA, Bloomberg.

net oil-consuming Provinces (chart 3). For these same Provinces, the upward revisions to calendar 2017 growth are likely to transform the modest combined deficit outlined in their FY18 budgets to an aggregate surplus, albeit smaller than the FY17 balance. For the three major oil-producing Provinces, their combined deficit should begin to narrow in FY18.

Following two years of budgets outlining relatively weak revenue gains for the upcoming year, this spring's budgets were more upbeat. Anticipated gains in provincial receipts as FY18 progresses are expected to spur additional programme spending. This should help to narrow existing social programme gaps; but going forward, with economic growth trending lower, increased spending commitments will likely complicate the Provinces' challenge in trimming their net debt burdens back towards pre-recession levels.



Sources: Scotiabank Economics; *Budget* documents.

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
2016p*	1.5	1.9	2.4	0.9	1.4	1.7	2.6	2.4	-1.0	-3.8	3.7
2017f	2.7	-1.8	1.4	1.4	0.9	2.3	2.9	2.3	1.9	2.9	3.0
2018f	1.9	-0.3	1.3	1.2	0.8	1.7	2.1	1.9	2.0	2.3	2.2
Nominal GDP											
2000–15	4.4	5.7	4.3	3.3	3.3	3.6	3.8	4.5	6.0	6.5	4.5
2016e	2.1	-0.1	3.7	2.4	2.5	3.0	4.2	3.7	-3.5	-6.0	5.4
2017f	5.2	2.4	3.1	3.3	2.7	4.4	5.2	4.4	5.1	6.8	5.3
2018f	3.9	2.7	2.8	2.8	2.2	3.4	4.0	3.6	4.2	5.0	4.0
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	1.5	-2.6	1.8	0.6	0.6	1.6	1.4	0.9	0.4	1.0	2.6
2018f	0.9	-1.1	0.3	0.3	0.2	0.8	1.1	0.7	0.6	0.9	1.2
Unemployment Rate (%)											
2000–15	7.1	14.3	11.2	8.9	9.6	8.1	7.2	5.1	4.9	4.9	6.6
2016	7.0	13.4	10.7	8.3	9.5	7.1	6.5	6.1	6.3	8.1	6.0
2017f	6.6	14.5	10.1	8.1	8.7	6.3	6.1	5.6	6.1	8.2	5.5
2018f	6.5	14.9	10.0	7.9	8.6	6.2	6.1	5.5	5.9	7.9	5.4
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	202	1.1	0.8	4.1	1.7	41	80	7.2	4.5	26	36
2018f	190	1.1	0.6	3.8	1.7	38	75	5.7	4.5	26	34
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	2,000	31	8	54	42	456	822	59	59	245	224
2018f	1,980	29	7	54	41	450	812	58	60	248	221
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	-22,000	-1,080	-18	41	-231	250	-1,524	-872	-1,289	-10,784 †	2,775 †
2018f	-24,500	-778	1	136	-192	0	0	-840	-685	-10,344	295

* Real GDP by industry at basic prices. ** MB:FY04-FY15; AB:FY05-FY15; SK:FY15-FY18f: ex pension accrual adjustment. † Final FY17; other FY17 & FY18: Provinces' estimates.

United States

- **Our outlook is changed only modestly from the previous quarter as the diminished prospects for fiscal stimulus are offset by the abatement of a variety of risks to US growth. As a result, we shaved our growth projections marginally to 2.2% in 2017 and to 2.2% in 2018.**
- **Aside from geopolitical developments, policy mistakes are still the main risk to the US outlook, but consumer demand, rising industrial activity, and increased investment all appear increasingly resilient to missteps from Washington.**

LEARNING TO LOVE THE LATE CYCLE

As the US economy heads into the eighth year of what is now its third-longest expansion, the fundamentals for continued solid growth remain in place, though any slack in the economy is rapidly closing with the economy at full employment. Our outlook is changed only modestly from three months ago.

On one hand, we have removed nearly all of the very limited additional fiscal stimulus that we had programmed in 2017 and 2018 on the current expectation that virtually no meaningful tax reform or expanded infrastructure spending is likely to be implemented by the US federal government over the next 18 months. On the other hand, a variety of material risks to the US outlook have abated: the USD has weakened, bond yields are lower for longer than expected, financial conditions have materially eased, oil prices are lower than projected, and trade policy risks are proving to be more bark than bite, thereby generating less of a drag than expected on investment.

Taking all of these factors into account, our projections for US growth have been shaved only slightly from our last *Global Outlook*, down from 2.3% to 2.2% in 2017, and from 2.4% to 2.2% in 2018. Growth continues to be driven by support from a strong labour market, rising consumption, recovering capex, and a slightly better external picture, all of which should compensate for a relatively soft Q1.

STRONG CONSUMER DEMAND REFLECTS STRONG LABOUR MARKETS

Consumption growth in Q1 dipped to its lowest rate in several years, but we expect it to regain its footing through the remainder of 2017 and lead overall growth into 2018 on the back of strong labour markets, accelerating wage growth, solid household balance sheets, and positive consumer sentiment. The most recent data show a solid rebound in spending after the winter's lull and consumer confidence is near its highest levels in a decade and a half.

Strong consumer demand reflects strong labour markets. Unemployment at 4.3% is some 30 bps below the Fed's 4.6% estimate for the non-accelerating inflation rate of unemployment (NAIRU). Both narrowly- and broadly-defined indicators of joblessness are at decade lows, while the number of job openings is at a record high of more than 6 mn. The NFIB survey shows hiring plans for the next three months at their highest levels in 16 years, though the pace of hiring has slowed. Monthly job gains averaged just 121,000 in the March to May period compared

CONTACTS

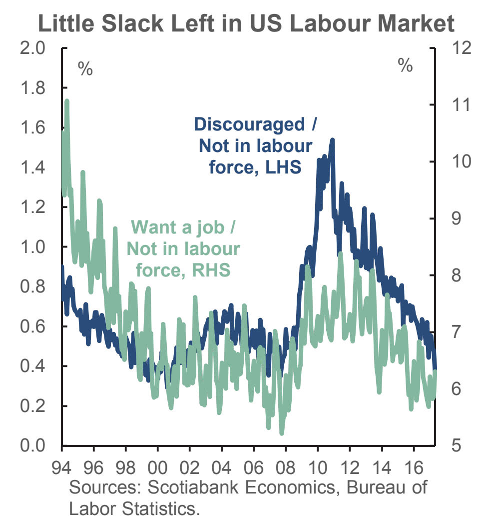
Brett House, VP & Deputy Chief Economist
416.863.7463
Scotiabank Economics
brett.house@scotiabank.com

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, Bureau of Labor Statistics.

with 201,000 over the prior three months. Business surveys point to increasing skilled labour shortages. Immigration restrictions have likely added to labour shortfalls in some sectors such as agriculture and construction.

Labour market participation, however, remains weak at just below 63%. Yet, it's not clear that there is a reserve pool of people ready to re-enter the work force. In fact, there appears to be little slack at all left in the labour market. The share of people outside the labour force who say they want a job is only 6.3% compared with an all-time low of 5.2% in October 2007 (chart 1). Similarly the share of people outside the labour force who say they're not looking for work because of discouragement over job prospects is, at 0.37%, near 2007's low of 0.35%.

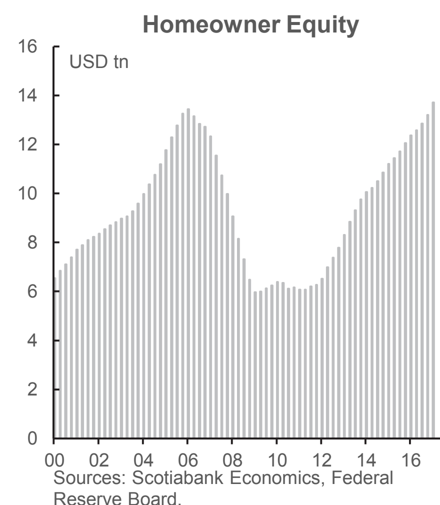
Modest wage gains should begin to accelerate with the unemployment rate so low. Growth in average hourly earnings has been stuck in a narrow 2.5–3.0% y/y range over the past year, only marginally above underlying inflation trends, held back by competitive pressures and weak labour productivity. Still, this represents an acceleration in wage growth from around 1.9% y/y in 2012. Real wage gains are outpacing productivity growth and labour's share in US GDP is rising. Relatively low-income, less-credentialed workers are seeing the quickest wage gains, which should ensure a further boost in aggregate demand.

HOUSEHOLD FINANCES ARE SOUND

US household balance sheets are on a solid financial footing. Household net worth is at a record high, household debt relative to income is at a 15-year low, and debt-service ratios are at historic lows. Homeowner equity has more than doubled in the past five years (chart 2).

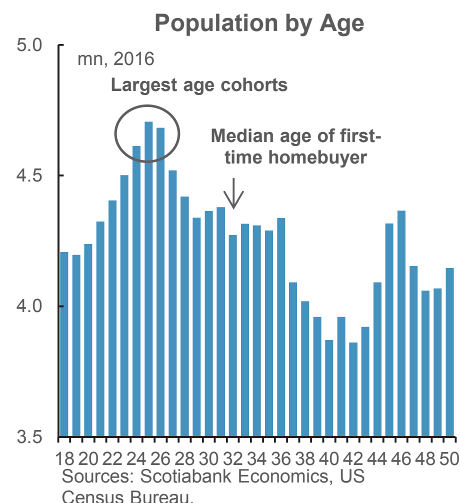
Financial conditions have broadly eased since the beginning of the year owing to a slightly weaker dollar, lower yields on US Treasuries, and stronger equity markets, which should together provide further support to US households. Consumer credit is growing healthily, while most delinquency rates remain low and stable. Lower energy prices are providing an additional boost to household purchasing power in the near-term.

Chart 2



Sources: Scotiabank Economics, Federal Reserve Board.

Chart 3



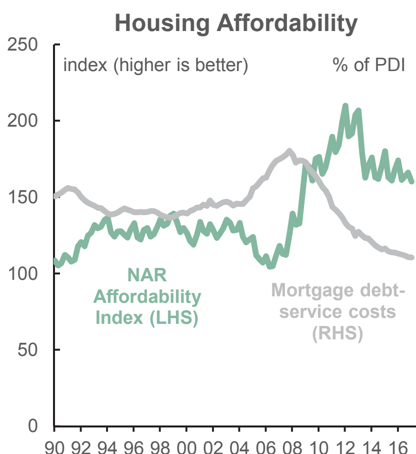
Sources: Scotiabank Economics, US Census Bureau.

Table 1 — Quarterly US Forecasts

	2016				2017				2018			
	Q1	Q2	Q3	Q4	Q1	Q2e	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Economic												
Real GDP (q/q ann. % change)	0.8	1.4	3.5	2.1	1.4	2.7	2.4	2.2	2.1	2.1	2.0	2.0
Real GDP (y/y % change)	1.6	1.3	1.7	2.0	2.1	2.4	2.2	2.2	2.4	2.2	2.1	2.1
Consumer prices (y/y % change)	1.1	1.1	1.1	1.8	2.6	2.0	2.1	2.0	2.0	2.4	2.3	2.3
CPI ex. food & energy (y/y % change)	2.2	2.2	2.2	2.2	2.2	1.8	1.9	1.9	2.0	2.3	2.3	2.3
Financial												
Euro (EURUSD)	1.14	1.11	1.12	1.05	1.07	1.14	1.12	1.13	1.15	1.18	1.20	1.20
U.K. Pound (GBPUSD)	1.44	1.33	1.30	1.23	1.26	1.30	1.28	1.28	1.28	1.28	1.31	1.31
Japanes Yen (USDJPY)	113	103	101	117	111	112	110	110	112	112	115	115
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	1.01	1.05	1.30	1.30	1.55	1.70	1.90
2-year Treasury (%)	0.72	0.58	0.76	1.19	1.25	1.38	1.50	1.65	1.75	1.85	1.95	2.10
5-year Treasury (%)	1.20	1.00	1.15	1.93	1.92	1.89	1.95	2.10	2.25	2.40	2.55	2.60
10-year Treasury (%)	1.77	1.47	1.59	2.44	2.39	2.30	2.35	2.50	2.70	2.90	2.95	3.00
30-year Treasury (%)	2.61	2.28	2.31	3.07	3.01	2.83	2.90	3.15	3.35	3.40	3.45	3.50

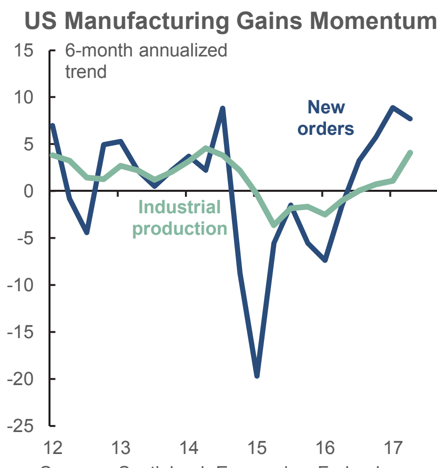
Nonetheless, consumer spending growth during 2017–18 is expected to slow from the average 2.9% annual advance of the prior three years. Auto sales appear to be plateauing amid a tightening in lending standards and a fade in pent-up demand. Following last year's record-setting performance, auto sales adjusted for population growth have returned to their long-term trend.

Chart 4



Sources: Scotiabank Economics, NAR, US Federal Reserve.

Chart 5



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

Stalled health-care reform, possible cuts to social programmes, and delayed income tax reductions also could temper consumer enthusiasm. Refinancing activity is likely to moderate over the coming year as mortgage rates move higher. Tougher immigration policy and a still-strong US dollar are dampening tourism inflows, with reports pointing to a drop in international flight and hotel bookings to the United States for the summer months.

HOUSING OUTLOOK POSITIVE, BUT RESTRAINED

The outlook for US housing is positive, though restrained. The fundamental drivers of housing demand—low unemployment and low interest rates—remain supportive. From a demographic perspective, the pool of potential buyers remains sizeable. The largest population cohort in the United States is currently aged 24–26 and totals some 14 mn (chart 3); its members should soon be entering the homeownership market.

Yet, a number of factors are starting to crimp a faster pace of home sales, most notably among first-time buyers whose share of overall transactions remains below historical norms. These include a persistently low level of listings, especially for entry-priced homes; still-tight credit conditions; and record high student-loan debt. Meanwhile, rising home prices are leading to worsening affordability conditions that will be exacerbated by any potential rise in interest rates (chart 4).

Housing starts are forecast to strengthen to 1.23 and 1.33 mn units, respectively, in 2017 and 2018. However, these levels still fall short of long-term demographic demand, which we estimate at around 1.4 mn. While builder confidence remains high, construction is being held back by skilled labour shortages, rising land costs, and increases in construction prices. Construction timelines from start to completion have steadily lengthened since 2013.

Table 2 — United States

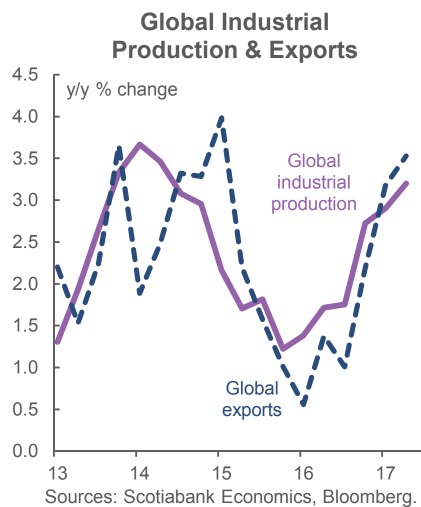
	2000–15	2016	2017f	2018f
	(annual % change, unless noted)			
Real GDP	1.9	1.6	2.2	2.2
Consumer spending	2.3	2.7	2.6	2.6
Residential investment	-0.7	4.9	4.5	2.6
Business investment	2.4	-0.5	3.8	2.9
Government	1.0	0.8	0.2	0.6
Exports	3.8	0.4	2.9	2.5
Imports	3.5	1.1	4.3	3.5
Nominal GDP	4.0	3.0	4.2	4.2
GDP Deflator	2.0	1.3	1.9	2.0
Consumer price index (CPI)	2.2	1.3	2.2	2.2
CPI ex. food & energy	2.0	2.2	2.0	2.2
Pre-tax corporate profits	5.9	-0.1	4.1	3.5
Employment	0.6	1.8	1.4	1.2
Unemployment rate (%)	6.3	4.9	4.4	4.3
Current account balance (USD bn)	-511	-452	-488	-534
Merchandise trade balance (USD bn)	-668	-753	-827	-890
Federal budget balance (USD bn)	-529	-585	-625	-655
percent of GDP	-3.8	-3.2	-3.2	-3.2
Housing starts (mn)	1.27	1.18	1.23	1.33
Motor vehicle sales (mn)	15.4	17.5	17.4	17.6
Industrial production	0.8	-1.2	1.5	2.0
WTI oil (USD/bbl)	64	43	51	53
Nymex natural gas (USD/mmbtu)	5.09	2.55	3.10	2.95

INDUSTRIAL ACTIVITY GAINS MOMENTUM

US industrial activity continues to strengthen even as orders in the transportation sector, especially for commercial aircraft, have fallen to a seven-year low. The

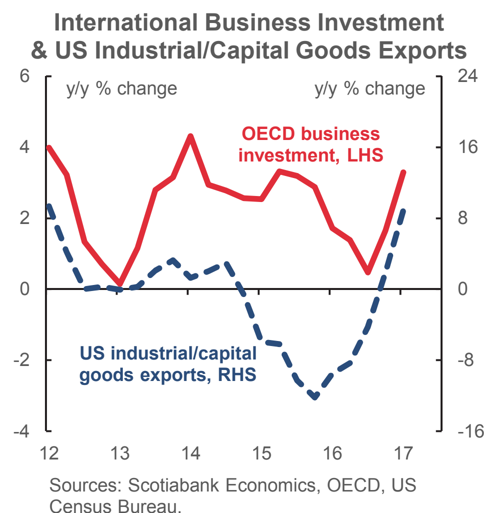
improvement is broad-based, with demand for both durable and non-durable goods advancing year-over-year at the fastest pace in several years and continuing to outpace output gains (chart 5). The backlog of unfilled orders is also on the upswing, which points to some further acceleration in US industrial activity in the second half of 2017. Consumer products—which account for more than 40% of overall US industrial activity—continue to lead the way, with year-to-date demand rising at the quickest pace in six years. However, orders for metal products and machinery are also on the upswing, pointing to improving overall business conditions in the United States and across the globe. In fact, while some 'soft data', such as purchasing managers surveys, have moderated in recent months, 'hard data', such as industrial production at factories around the world is advancing at the fastest pace in nearly three years, providing a significant boost to global exports and shipping activity (chart 6).

Chart 6



Sources: Scotiabank Economics, Bloomberg.

Chart 7



Sources: Scotiabank Economics, OECD, US Census Bureau.

INVESTMENT SPENDING PICKS UP

Overall US business investment growth hit its fastest rate in five years during Q1. While we don't expect this pace to continue through the rest of the year, the progressive easing in financial conditions for business since the end of 2016 should sustain investment growth through the end of 2017. Increased borrowing is supporting investment growth: the ratio of debt to nonfinancial corporate income has nosed toward 92%, taking this ratio near to its pre-2008 peak of around 95%. Business investment is expected to account for about a quarter of overall GDP growth in 2017, its largest contribution in three years.

US business investment is being led by more than a 50% jump in oil and gas investment since the third quarter of 2016. Capital expenditures have also started to improve in other sectors, lifting non-energy investment at its fastest pace in nearly two years. Spending is strongest for high tech and industrial equipment, which climbed at double-digit annualized rates in the opening months of 2017, nearly four times the average growth of the previous four years. Some businesses have even started to break ground on new buildings, lifting capital expenditures on new structures 8% y/y in early 2017, the best performance in nearly three years. While plant utilization rates still remain 3.5 ppts below their historical average, utilization rates have begun to move steadily higher, climbing 0.5 ppts in recent months. Further improvement in construction activity is likely in the second half of 2017, especially since profit margins and revenue growth have picked up across the US industrial sector. Demand for cement and other construction materials has already started to trend higher, with rail volumes of these products currently advancing at the fastest pace since late-2014.

Investment spending also appears to be trending higher in other countries, lifting global machinery exports at a double-digit year-over-year pace since the opening months of 2017. This represents a sharp reversal from declining trade volumes during the past two years. This trend is reinforced by data from several multinational machinery suppliers that have raised their full-year 2017 revenue and earnings guidance in recent months alongside strengthening global demand. Overall, this pattern points to a further acceleration in US industrial and capital-goods exports. These products account for two-thirds of overall exports and are now advancing at the fastest pace in six years (chart 7).

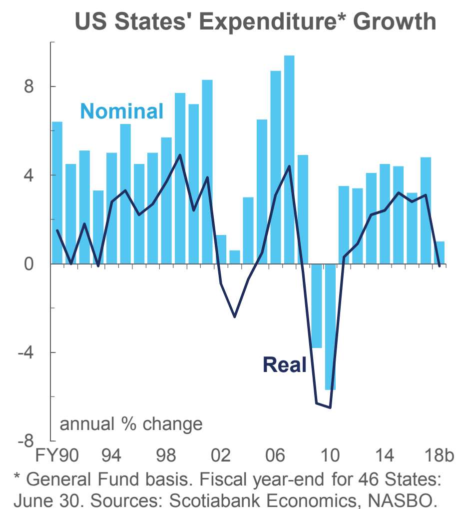
LITTLE ADDITIONAL FISCAL STIMULUS EXPECTED

We expect that federal spending will still rise in calendar 2018: health reform is expensive and we project some visible outlays on priorities such as defense ahead of the November 2018 mid-term elections. Caution on budget management at the State level will only partially offset these outlays.

The contribution of governments' current and capital spending to real GDP growth is expected to be negligible in calendar 2017, followed by a small contribution of 0.1 ppts in calendar 2018. Our projected widening of the US federal deficit by USD 40 bn in fiscal 2017 largely reflects mandatory programmes plus weak revenue growth as individuals and corporations manage income to defer tax payments until after the promised tax-rate cuts are implemented. Negotiations on substantive federal tax reform now appear to be significantly delayed, with any eventual implementation now pushed past end-2018. The President's 10-year infrastructure boost remains sufficiently vague that several major municipalities are framing their own financing structures to proceed with urgently required construction.

An early look at State budgets for fiscal 2018 indicates that aggregate General Fund spending increases are expected to slow from 4.8% last year to 1.0% in FY18 (chart 8). States are principally preoccupied by concerns about their capacity to finance their future Medicaid obligations in light of proposals from Washington that would impose caps on federal contributions. A range of other cutbacks proposed by the US administration, from reductions in rental assistance to more modest funding for environmental programmes beyond new EPA guidelines, are, together, adding to caution in budget management at the State level.

Chart 8



* General Fund basis. Fiscal year-end for 46 States: June 30. Sources: Scotiabank Economics, NASBO.

EXTERNAL RISKS REMAIN LIVE, BUT MUTED

Exports grew solidly in Q1 despite a relatively strong USD. With the Fed expected to continue on its tightening path while the ECB and BoJ remain on hold, the USD should stay relatively solid against most major global currencies; hence, we expect imports to grow faster than exports in both 2017 and 2018 as both consumers and business take advantage of relatively cheap USD prices on foreign goods. Overall, net trade is expected to exert a drag on the economy, reducing overall GDP growth by 0.3 ppts in both 2017 and 2018. This is likely to keep the broader current account deficit more or less unchanged over the next couple of years: the deficit is expected to increase from 2.4% of GDP in 2016 to 2.5% in 2017 and 2.6% in 2018.

The US administration's early self-inflicted wound through its January withdrawal from the Trans-Pacific Partnership (TPP) is unlikely to be repeated with NAFTA, where we expect renegotiations to produce a mutually beneficial updating of the agreement. Similarly, we discount talk of widespread tariffs on steel as sabre-rattling that is unlikely to be matched with action.

US & Canadian Monetary Policy & Capital Markets

Inflation—or rather the apparent lack thereof and whether or not soft readings are transitory—is at the crux of the debates over the future course of US, Canadian and indeed global monetary policy direction. Both the Federal Reserve and Bank of Canada guide with considerable conviction that low and falling inflation rates are driven by transitory factors that will revert higher and align with 2% inflation objectives into 2018.

Our house forecast is more cautious than central bank guidance on balance. We project fewer hikes by the Federal Reserve than the median projection provided by FOMC officials. We also expect a hiking cycle in Canada to go only a little further over 2017–18 than to simply unwind rate cuts that were taken out as insurance against downside risks back in 2015.

BANK OF CANADA—HIKING WITH INFLATION UNDERSHOOTING?

Our forecast is for three 25bps rate increases with one hike per quarter starting in July and then hikes in October and 2018Q1. This would reverse the insurance taken out through two rate cuts in 2015 that were designed to counter downside risks following the collapse in commodity prices that began in mid-2014. It would tentatively add one more hike to reversing the earlier downside insurance to a) account for the fact that spare capacity is largely shut by the traditional output gap measure and b) to take out monetary policy insurance against upside risks to the economy in the wake of a persistently stronger-than-anticipated economy. A pure modelling approach would predict 100bps of hikes by next summer but we have shaved this somewhat through imposed judgement.

Why hike? Go here for a further explanation of our call and here for a note on why the currency poses no obstacle to raising rates around present or slightly richer values. These arguments are buttressed by the following points.

1. The BoC said it would hike—and fairly soon at that—in language that was presumably carefully chosen to be a cue to markets. Senior Deputy Governor Wilkins said in her June 12th speech that the BoC "will be assessing whether all of the considerable monetary policy stimulus presently in place is still required" and "As we work toward our interest rate decision on 12 July, we will be focusing on the data and talking to many people like you to get a better sense of what is happening on the ground." Governor Poloz and his deputies have said that the oil shock is behind the nation and that the rate cuts of 2015 have done their work, which is taken as language signalling a need to end emergency levels of monetary policy stimulus. When given the chance to rein in the market reaction to their words, Governor Poloz passed on three separate occasions which implies that they got the reaction they intended.

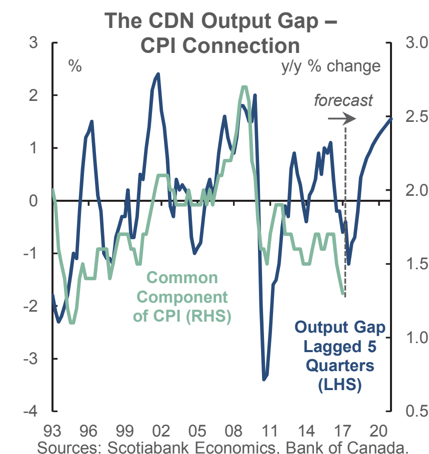
2. Growth is running at a rate well above what the BoC estimates to be the economy's noninflationary speed limit of about 1½%. It was 4.2% in Q3, 2.7% in Q4 and 3.7% in Q1 with '17Q2 tracking around 2½%. It has become rather difficult to keep dismissing transitory upsides to growth.

3. As a consequence, the conventional output gap has been closed off and suggests that inflation will rise into 2018 given the lagged relationship (chart 1).

CONTACTS

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

Chart 1

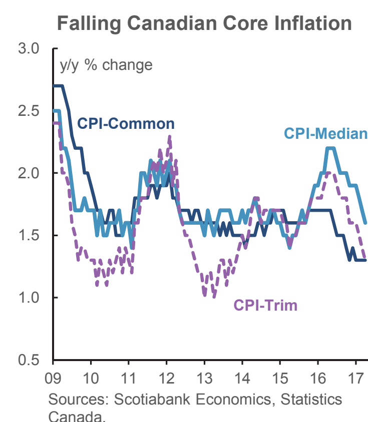


Sources: Scotiabank Economics, Bank of Canada.

Chart 2

Sources: Scotiabank Economics, Statistics Canada.

Chart 3



Sources: Scotiabank Economics, Statistics Canada.

4. Job growth has been running at a torrid pace. Since last July, Canada has created about 400,000 jobs in seasonally adjusted and annualized terms. Not since 1979 have over 400,000 jobs been created in a single year. The unemployment rate has dropped to 6.6%. Tightening labour markets, waning effects of the collapse in commodity prices and large minimum wage hikes in Ontario and Alberta should propel wage growth into 2018 (chart 2).

5. Canada is not importing the shock to bond yields driven by US fiscal policy developments that the BoC acknowledged earlier in the year; indeed, the opposite has rung true as sovereign borrowing costs have fallen and eased financial conditions.

6. Trade policy risks are being continuously pushed out in time. A US border tax seems unlikely, and so does a tearing up of NAFTA. Monetary policy has to assume at this point that trade policy risk will exist for years and beyond the unlikely US desire for negotiations to be completed by this Fall, and then act accordingly with information at the time.

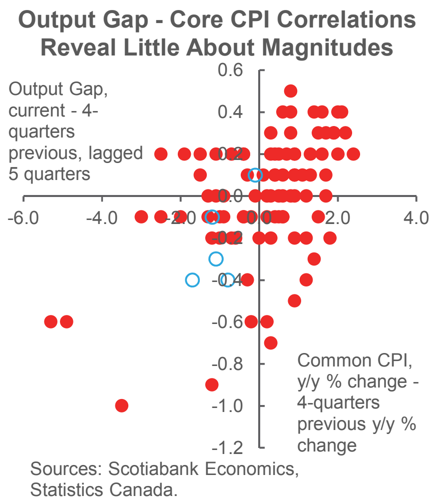
7. With consumer spending continuing to grow at a fairly rapid pace and investment perhaps joining the picture, there are limits to which one can ignore persistent upsides while waiting for greater traction on exports.

Why not hike? That too is a lengthy list and if not for altered BoC guidance it would be a fairly simple tale to tell against monetary tightening. Core inflation is subdued and continues to decline (chart 3) which extends the inability of the BoC to get inflation up to its 2% target to six consecutive years and counting. Wage growth may be bottoming but is still very low (non-existent in real terms). There also remain question marks over the durability of growth drivers. Record highs across most housing and consumer variables counsels caution to not roll over the engines of growth.

Fundamentally, the case for going slowly comes back to why core inflation is tracking lower. The output gap framework relied upon by the Bank of Canada has over-predicted core inflation over recent quarters and performed worse than average (chart 4). Each dot in that chart represents coordinates for the size of the estimated output gap and core inflation in a particular quarter dating back to the early 1990s; the blue dots highlight the recent quarterly experiences with the lowest being this year's. That output gaps don't explain it all in terms of inflation modelling is highlighted by the fact that Canada is registering a 22-year low in core inflation. That's despite closing off spare capacity and having much less spare capacity a year or two ago than existed in the depths of the 2009 recession when core inflation was persistently higher.

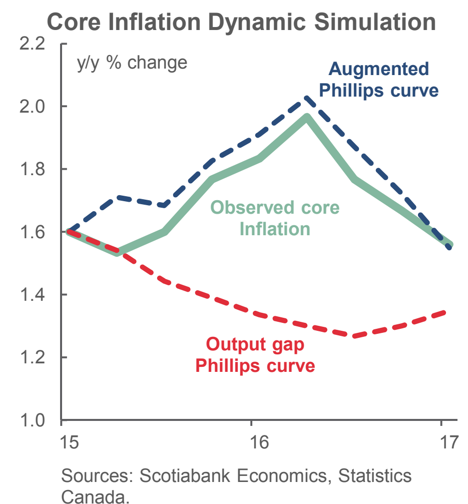
We therefore broaden the explanatory modelling tools. An augmented Phillips curve estimated in the Scotiabank Global Macroeconomic Model outperforms a standard Phillips curve estimation of the output gap–inflation relationship with the comparison shown in chart 5. The model adds unit labour costs, oil prices and food prices to the estimation that includes an output gap variable and the real effective exchange rate in order to account for more influences upon inflation than just spare capacity and exchange rate arguments. The model predicts that core inflation will initially stabilize around 1.2–1.3% before gradually rising to about 1.8% by the end of 2018 (chart 6). That would be progress toward the BoC's inflation mandate but continue to fall short of it over our forecast horizon.

Chart 4



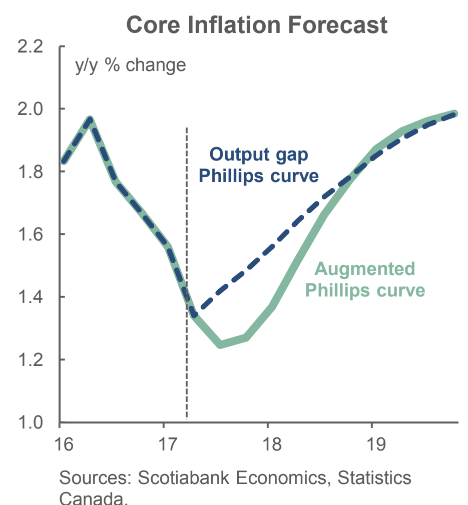
Sources: Scotiabank Economics, Statistics Canada.

Chart 5



Sources: Scotiabank Economics, Statistics Canada.

Chart 6



Sources: Scotiabank Economics, Statistics Canada.

Because of the uncertainty surrounding inflation modelling, the persistent undershooting of the BoC's 2% target, and an augmented approach that considers other factors beyond spare capacity pressures (like grocery store "wars"), we err on the side of a very limited amount of policy tightening followed by a prolonged assessment of the after-effects.

FEDERAL RESERVE — A SLOWER EXIT PATH

We project one more rate rise this year in December followed by two more in 2018. Our steady state assumptions for markets and growth assume that it will take until 2019 or later to achieve an estimated 2.75% nominal neutral policy rate (or "R-star") compared to the FOMC's average long-run policy rate forecast that has declined by 125bps over the past five years. That implies a cumulative 150bps of additional rate hikes spread over the next 2.5 years or longer. The FOMC is assumed to switch to rate targets from ranges once it has raised the fed funds target ceiling to 2% as the target becomes somewhat easier to enforce with further distance from the zero bound.

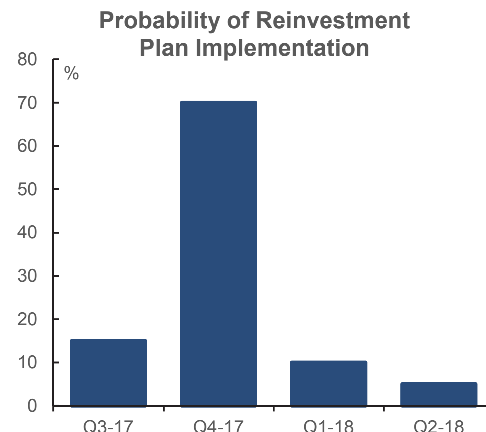
Unconventional policy is expected to migrate toward implementing the pre-announced initial reinvestment caps at US$6 billion for Treasuries each month and $4 billion for mortgage backed securities each month. Above these amounts, the Federal Reserve will continue to reinvest any securities as they roll over. The FOMC has pre-announced that these targets will be raised in quarterly increments to $30 billion for Treasuries and $20 billion for MBS over a one year period. We assume implementation of this plan by the December 2017 meeting (chart 7) after which a steady amount of securities will roll off the balance sheet.

While the Fed has provided minimal guidance on the long-run target for the size of the balance sheet, we forecast it to shrink to about US$2.5 trillion (from US$4.5 trillion at present) by 2025. By that point, we expect full balance sheet normalization to be engaged, with Fed notes outstanding (or currency in circulation) accounting for the lion's share of the liability side compared to the greater role played by bank reserves held with the Fed at present (charts 8, 9). It is assumed that currency in circulation will rise by a similar pace to nominal GDP but payments innovation may lean toward slower growth in notes issued by the Fed. Also, by that time, we expect Treasuries to become the more dominant instrument on the asset side of the balance sheet compared to the greater mixture between Treasuries and MBS at present.

The steady state set of market and growth assumptions for the next several years required to fully restore the balance sheet to more normal conditions is likely unrealistic. Instead, there is the potential for a return of a future round of quantitative easing in the context of what is already a maturing eight-year-old expansion and hence the third longest on record. The Fed guides against this—as is to be expected—but classic late cycle signs already include elevated stock markets, low unemployment and high confidence. This is why we judge risks to our balance sheet forecast to be more skewed toward a larger balance sheet than a smaller one in addition to the need for currency in circulation to rise with long-run economic growth.

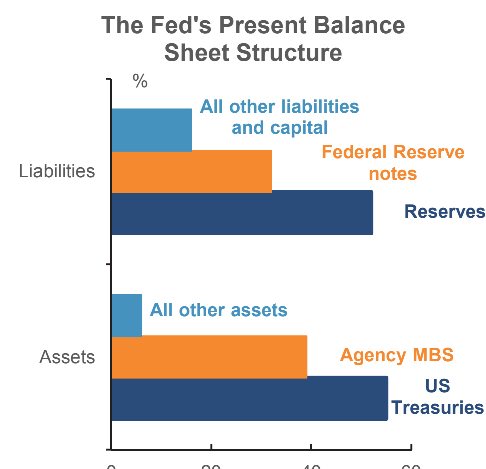
Long before we get to that point, however, there is the question of the appropriateness of continuing along a tightening path in the face of uncertainty over low core inflation readings. The Fed is likely looking through a soft-patch on inflation partly because it believes the effects to be transitory but also because it believes

Chart 7



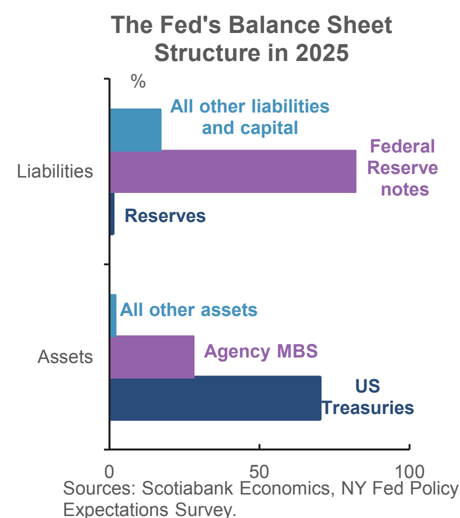
Sources: Scotiabank Economics, NY Fed Policy Expectations Survey.

Chart 8



Sources: Scotiabank Economics, NY Fed Policy Expectations Survey.

Chart 9



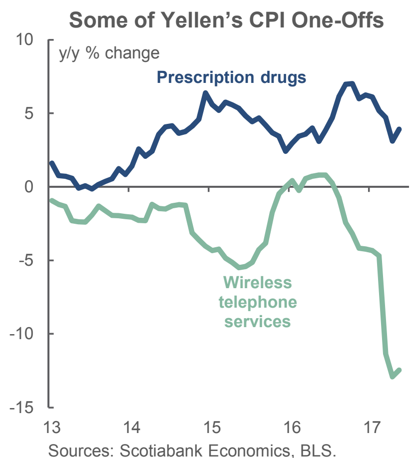
Sources: Scotiabank Economics, NY Fed Policy Expectations Survey.

that heading off inflationary forces is less damaging than putting the genie back in the bottle if it falls behind. Because we're more cautious toward US inflation dynamics and the durability of stock market gains in anticipation of fiscal stimulus, we've erred on the side of a slope shift in the pace of rate hikes from 75bps in the past seven months to 75bps over the next eighteen.

Indeed, reasons for cautioning against purely looking through soft inflation include a) the transitory factors operating to the downside of late may not be so transitory (chart 10); b) there are also potentially transitory upsides to core inflation measures as shown in chart 11; and c) the lion's share of the CPI basket is exhibiting extraordinarily little pressure in either direction which is also shown in chart 11.

Nevertheless, we believe that a Phillips curve explanation of inflation through spare capacity and unemployment arguments will reassert itself in favour of gentle upward pressure upon inflation into 2018. As the US shuts spare capacity, downside risk to inflation readings should transition the other way.

Chart 10



Sources: Scotiabank Economics, BLS.

YIELD CURVES

We expect to remain in a low bond yield environment throughout our forecast horizon. Mild upward pressure continues to be expected with a cumulative 75bps higher US 10 year Treasury yield projected by the end of 2018 and with 10 year Canada yields trading a half point beneath that.

Indeed, the narrowing of the negative Canadian rate differential to the US is among the more significant bond market moves of late. From about 90bps beneath US 10s, the negative spread differential in Canadian 10s has been cut almost in half. We project this rate differential to remain intact over our forecast horizon. One argument for preserving a rate differential is rooted in relatively less risk of supply pressures in Canada than the US debate over potentially easier Senate rules for deficit financed US stimulus. One argument for a narrower negative differential than previously is that vulnerable risk assets could spark a disproportionate flow into Treasuries relative to Canadas.

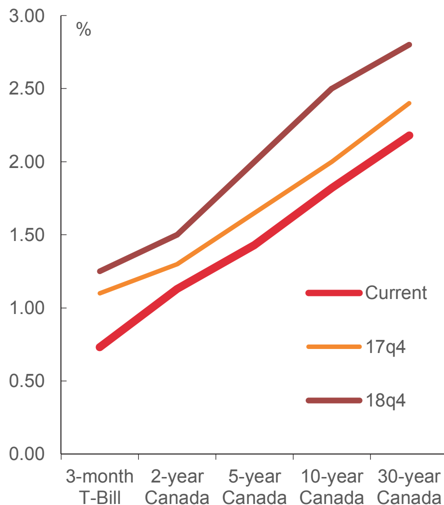
Ultimately we assume that higher term premia and upward pressure upon the whole term structure of interest rates in both countries will be partly driven by balance sheet unwinding at the Federal Reserve. Nevertheless, the limit to this upward pressure is likely to be the so-called R-star equilibrium rate of interest that is estimated to be 2½–3% in both countries. An ongoing carry trade out of European and Japanese debt and rising structural factors in support of demand for fixed income instruments should also moderate the magnitude of upward pressure upon the yield curves over time.

For our rate forecasts, please see the next page.

Chart 11

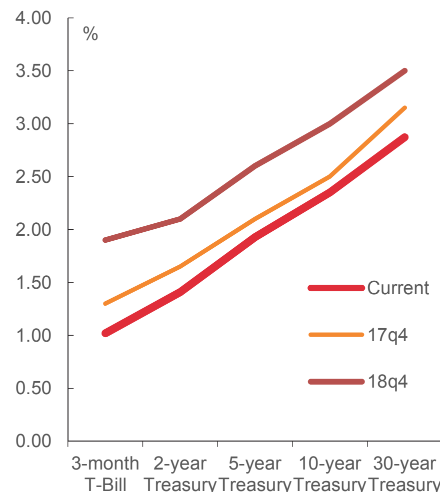
Source: Scotiabank Economics.

Chart 12



Sources: Scotiabank Economics, Bloomberg.

Chart 13



Sources: Scotiabank Economics, Bloomberg.

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

	2016				2017 (end of quarter, %)				2018			
Canada	**Q1**	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3f**	**Q4f**	**Q1f**	**Q2f**	**Q3f**	**Q4f**
BoC Overnight Target Rate	0.50	0.50	0.50	0.50	0.50	0.50	0.75	1.00	1.25	1.25	1.25	1.25
Prime Rate	2.70	2.70	2.70	2.70	2.70	2.70	2.95	3.20	3.45	3.45	3.45	3.45
3-month T-bill	0.45	0.49	0.53	0.46	0.55	0.71	0.90	1.10	1.30	1.30	1.25	1.25
2-year Canada	0.54	0.52	0.52	0.75	0.75	1.10	1.20	1.30	1.35	1.40	1.45	1.50
5-year Canada	0.68	0.57	0.62	1.11	1.12	1.39	1.50	1.65	1.75	1.85	1.90	2.00
10-year Canada	1.23	1.06	1.00	1.72	1.63	1.76	1.85	2.00	2.10	2.25	2.40	2.50
30-year Canada	2.00	1.72	1.66	2.31	2.30	2.15	2.20	2.40	2.50	2.60	2.70	2.80
United States	**Q1**	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**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	1.01	1.05	1.30	1.30	1.55	1.70	1.90
2-year Treasury	0.72	0.58	0.76	1.19	1.25	1.38	1.50	1.65	1.75	1.85	1.95	2.10
5-year Treasury	1.20	1.00	1.15	1.93	1.92	1.89	1.95	2.10	2.25	2.40	2.55	2.60
10-year Treasury	1.77	1.47	1.59	2.44	2.39	2.30	2.35	2.50	2.70	2.90	2.95	3.00
30-year Treasury	2.61	2.28	2.31	3.07	3.01	2.83	2.90	3.15	3.35	3.40	3.45	3.50

Mexico

LESS GLOOM AND MORE INFLATION

- **The threat to NAFTA appears to have subsided, lifting the outlook for Mexico's economy and producing a significant upward revision in our growth forecast.**
- **Inflation has been accelerating more than expected and becoming a bigger risk, as the pass-through from the FX depreciation kicked in and fuel price increases affected some other prices.**
- **Monetary policy has been activated rapidly to anchor inflationary expectations, with a 125 basis point increase in the reference interest rate year to date.**
- **Fiscal policy has also been used to restore fiscal discipline.**
- **The political environment will be now dominated by the upcoming electoral process of 2018.**

The outlook for the Mexican economy has been changing significantly in the last quarter. Economic growth expectations are not as grim as at the beginning of the year; however, even though there are some positive signs in certain sectors, they remain lacklustre. It seems that the largest part of the uncertainty surrounding the future of the North American Free Trade Agreement (NAFTA) has been lifted, since the Trump administration refrained from terminating it and decided to start the renegotiation process. This process will take some time and is unlikely to be completed this year. There is, however, a clear incentive for the three countries involved to finalize it as soon as possible, and if an agreement is reached in the next 9 months or so, then it is likely that it will be something better than the current NAFTA.

Now that the threat to terminate NAFTA appears to have dissipated, a heavy burden has been lifted from the Mexican financial indicators. The FX rate has notably appreciated (18%) since the peak reached just before the inauguration day, reaching pre-Trump levels below 18.0 MXN/USD (chart 1).

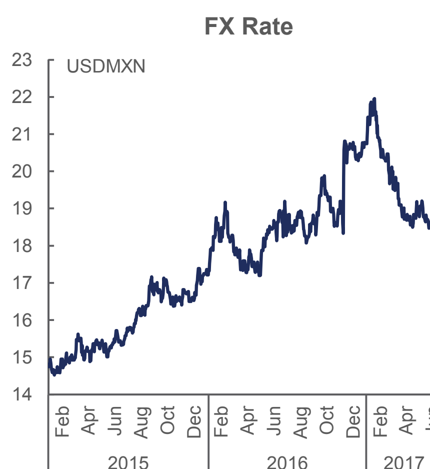
One of the key assumptions of the previous macroeconomic scenario was that investment was going to be significantly affected by the heightened uncertainty. And there was indeed some very noticeable impact on the investment side, as can be seen in the Non Residential Investment for the first three months of the year (chart 2). Now, anecdotal information gathered in different regions suggests that investment plans are being resumed, and that the actual impact will not be as deep and prolonged as previously assumed.

Another negative consequence can be seen in the inflation rate that, after reaching some of the lowest levels on record a couple of years ago, is now being impacted by a couple of factors: a sharp increase in fuel prices at the beginning of the year (as part of the liberalization process) and the long postponed pass-through effect from the sharp depreciation of the MXN since 2014. Recent evolution of inflation is

CONTACTS

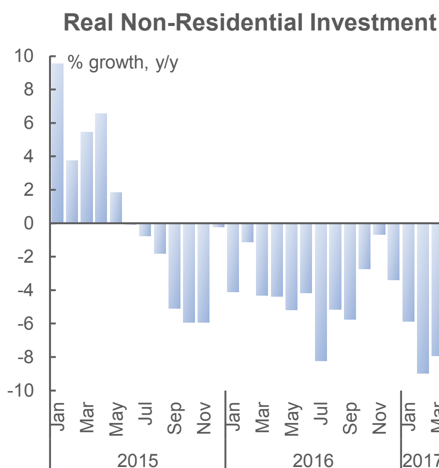
Mario Correa
52.55.5123.2683 (Mexico)
Scotiabank Mexico
mcorrea@scotiacb.com.mx

Chart 1



Sources: Scotiabank Economics, Bloomberg.

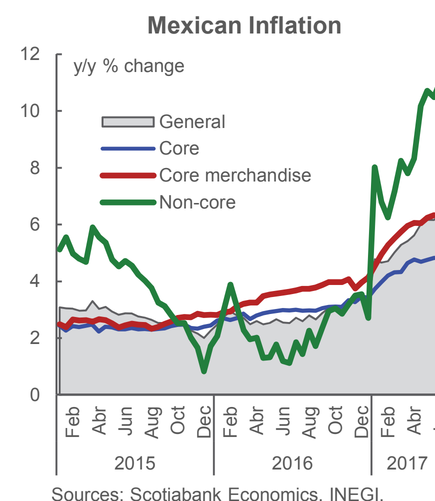
Chart 2



Sources: Scotiabank Economics, INEGI.

shown in chart 3. General inflation reached 6.3% y/y in the first half of June, the highest since 2009. Non-core inflation, which includes the more volatile components such as energy and agricultural prices, reached 11.07%, the highest since 2003! Core components reached 4.82%, well above the higher bound of the acceptable range for Banco de Mexico, and the merchandise part of the core inflation, which is clearly related to the FX, reached 6.31%. Even though this sharp increase in inflation is largely explained by transitory factors and should be absorbed rapidly during 2018, it poses a serious risk for inflationary dynamics. If second round effects appear, then medium- and long-term inflationary expectations could start increasing, and then inflation could easily remain stubbornly above the 4% level for longer than expected. Worth noting is that the number of components within the CPI rising above the 4% threshold is increasing, as can be seen in chart 4, and this represents a serious risk for inflationary expectations.

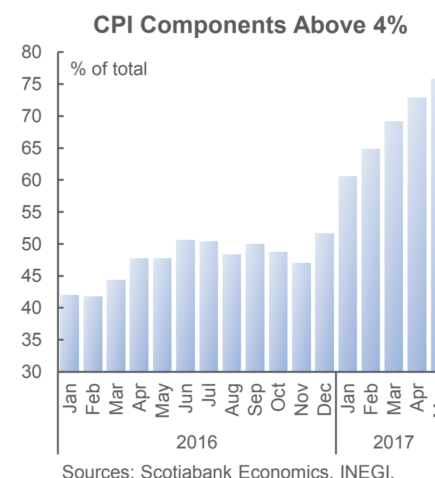
Chart 3



Sources: Scotiabank Economics, INEGI.

Monetary policy in Mexico has been reacting in response to this threat and to the changing conditions in global markets due to a more decisive Federal Reserve. The reference interest rate in Mexico has increased by 125 basis points year to date—a much faster pace than the one expected by the markets at the beginning of the year—reaching 7.0% in the last decision taken in June. Financial markets are now "thinking" that Banco de Mexico could be done with the rising cycle of interest rates, since one of the Board members voted to maintain the monetary stance at this meeting and the risk balance perceived by Banxico's Board is now neutral. Coming monetary policy actions will depend on inflation behaviour, and for the time being, we are still expecting one more 25 bp increase before the end of the year and one more in 2018, then stabilizing at 7.50% for many months.

Chart 4



Sources: Scotiabank Economics, INEGI.

Another significant reaction on the economic policy front is that of the fiscal policy. In the pre-budget document presented to Congress, the government is now aiming at a primary surplus of 0.5% of GDP for 2017 and 1.0% of GDP in 2018, reaching the inflection point of public debt in the present year. This represents a more disciplined state of public finances. Coupled with the extraordinary operation surplus obtained by Banco de Mexico as its foreign reserves appreciated, which amounted to 1.5% of GDP, this significantly reduced the risk of a downgrade in public debt ratings. Moody's already confirmed the current ratings and maintained a negative outlook due to several risks that remain. The other big rating agencies are expected to confirm the current ratings this year.

Within this less negative framework, we are markedly revising our GDP forecasts upwards, to 2.0% from 1.4% for 2017 in the last *Global Outlook*, and to 2.5% from 2.1% for 2018. Worth noting is that both levels are below the potential and that uncertainty remains high. Another significant change can be found in our FX forecast, which has been reduced along with the recent appreciation of the MXN. We are currently expecting the MXN to end the year at 19.63, and 20.01 MXN/USD for the end of 2018. Both levels are well above the current level due to the less favourable conditions expected in global financial markets as the Fed continues the normalization process of its monetary policy, the noise produced by Brexit and some geo-political tensions, and the approaching electoral process of 2018.

A special note should be made about the political environment. The race for the 2018 presidential elections is now the main issue, with a lot of internal struggle within the political parties and with the electoral logic prevailing on most government decisions. The only clear candidate who will be a contender is Andrés Manuel López Obrador (AMLO), whose populist speech generates anxiety within the business community as the polls mark him as the current leader of the contest. Of course, that is at least partially explained by the fact that the other candidates are not yet defined. There are visible divisions within the main political parties in determining the right candidate who would have a good chance to win, and the remainder of the year will be heavily charged with politics. Since there is a good chance that AMLO could become the next President and he could try to implement market-unfriendly policies, such as taking back the energy reform, there could be some extra uncertainty affecting investments and preventing stronger growth.

United Kingdom

GROWTH

- **UK growth has slowed and we expect a further slowdown over the remainder of the year, particularly centred on the consumer.**
- **Inflation has surged towards 3% and we expect further upside from here to almost 3½% y/y. Thereafter we expect inflation to revert back towards the 2% target relatively swiftly.**
- **Although the BoE has turned hawkish, with three dissenters for rate hikes, we expect muted wage inflation and pedestrian GDP growth to dissuade the Bank from raising Bank Rate this year.**

The outlook for GDP growth has softened since earlier in the year. In particular, Q1 GDP was much weaker than expected (at just 0.2% q/q) and the forward-looking indicators suggest that growth is unlikely to be any better over the remainder of the year. Indeed, the mechanism that caused GDP growth to slow by so much during Q1 is intensifying, suggesting that the headwinds to growth will build as the year progresses.

More specifically, inflation has surged, while employment growth and wage inflation have both slowed. The net result has been a stalling in real income growth, down from around 4% y/y a year ago, to just above zero currently. That has caused consumer spending growth to decelerate abruptly, bearing down on overall GDP growth (chart 1). While we expect a temporary, technical bounce in GDP growth during Q2 (by around 0.4% q/q), the second half of the year should see growth rates slow again to between 0.2% q/q and 0.3% q/q.

The net result is likely to be full year growth of 1.6–1.7% y/y during 2017. That is lower than the current BoE assumption of 1.8–1.9% y/y, which is based on quarterly growth rates of 0.4% q/q. The BoE is assuming that net trade and business investment will provide an offset to weak household consumption. In both cases this is plausible. In particular, weak household consumption implies slower import growth which will provide a boost to overall growth. Furthermore, the weak GBP exchange rate and robust overseas demand should support exports. However, while there is some logic to expecting business investment to accelerate, we are more cautious given the degree of uncertainty surrounding the Brexit negotiations and the recent General Election campaign.

INFLATION

Headline CPI inflation is now within a whisker of 3% y/y—the threshold above which the BoE Governor has to write to the Government to explain why inflation is so far above target and what it intends to do about it. We see around ½% of further upside from here, with inflation unlikely to slip back below 3% y/y until early 2018. However, the vast majority of the acceleration in inflation over the past year has been due to the effects of the sharp weakening in the GBP exchange rate.

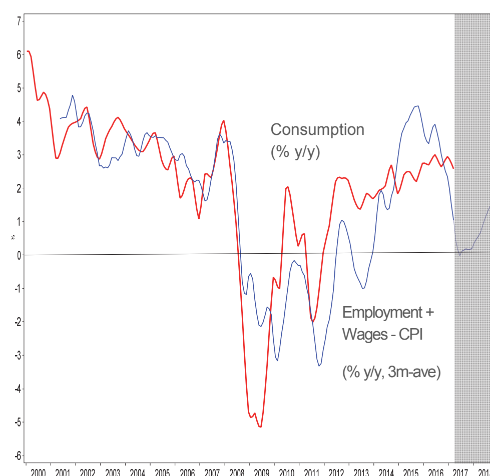
Meanwhile, domestically generated inflationary pressures have remained particularly subdued. Services inflation is typically used as a proxy for

CONTACTS

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

Chart 1

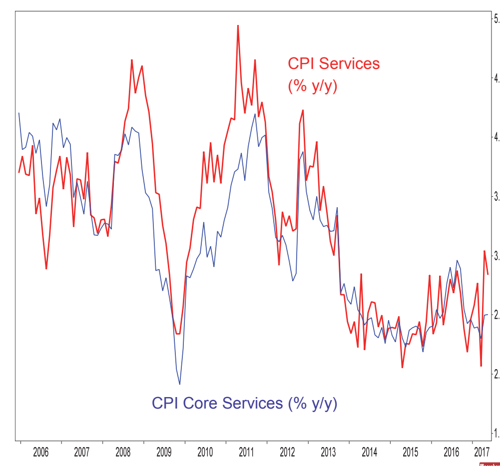
Consumption vs Real Disposable Income Proxy



Sources: Macrobond, Scotiabank.

Chart 2

Core Services CPI vs CPI Services



Source: Macrobond.

domestically generated inflation. However, this category also includes two components which are sensitive to movements in the exchange rate; namely package holidays and airfares. Stripping these components out of the services category, we find that there has been little, if any, acceleration in core services inflation (chart 2).

In turn, one of the biggest determinants of domestically generated inflation is wage growth, which is also particularly muted. While a lot of attention has been paid to the surprisingly large fall in the unemployment rate, we believe that this overstates the extent to which spare capacity (or supply of workers) has been eroded. In particular, unemployment may be low, but there has been a substantial increase in the supply of employment of migrant workers in recent years. This has meant that the supply vs demand dynamics are more balanced, helping to keep wage pressures muted. We suspect that could change once full-blown Brexit occurs. However, since that is still likely years away, nothing should change for now. That being said, with CPI inflation likely to be just above 3% around the turn of the year (around a percentage point above wage inflation) when the bulk of private sector pay deals are made, there could be some upwards drift during early 2018 as employees strive to maintain positive real wage growth.

POLICY

The BoE has taken some baby steps towards its first rate hike, though we believe that delivering the first move is still some way off. The latest decision showed three dissenters in favour of an immediate rate hike and the majority view was that tolerance to an inflation target overshoot had reduced. However, Governor Carney's subsequent Mansion House speech showed that in his view (and most likely that of the Deputy Governors) now is not the time for a rate hike. In particular, the Governor highlighted subdued domestic inflationary pressures and anaemic wage growth. We do not expect either to change any time soon, meaning that the majority on the committee are likely to oppose a rate hike this year. Moreover, with GDP growth likely to reside in the 0.2% q/q to 0.4% q/q range over the remainder of the year, we doubt that the MPC will have the appetite to raise Bank Rate at that stage.

The backdrop for a rate hike is likely to be more favourable during 2018. At that stage, we expect the pace of GDP growth to be on an upwards trajectory and there is more scope for wage inflation to accelerate. However, we doubt that there will be sufficient ammunition for a hike until the second half of the year.

There is considerable political uncertainty in the aftermath of the snap General Election, which resulted in a hung parliament. During the campaign, the Chancellor hinted that the pace of austerity would be moderated slightly. If delivered, it points to a small addition to GDP growth from 2018 onwards. We suspect that given the mood music (austerity fatigue, loss of popularity of the Conservative Party) there is room for even more relaxation of the fiscal plans. We will learn more when the Autumn Budget is presented later in the year.

Meanwhile, the formal Brexit negotiations have begun. The conventional wisdom is that the UK Government's bargaining position has been harmed having lost its parliamentary majority. In practical terms, the Government will have to agree terms with its European counterparts that are also palatable to remainers and Brexiteers alike; which is likely to prove incredibly challenging. The most important waypoints from an economic standpoint are likely to be whether or not the UK will be able to continue services (and particularly financial services) activity with the rest of the EU as well as whether a tariff-free border with the EU will continue.

Eurozone

- **We expect eurozone GDP growth to continue accelerating, in line with elevated survey readings.**
- **While inflation has recovered somewhat, this has largely been due to base effects. Meanwhile, core inflation has remained stubbornly below 1% as spare capacity remains plentiful.**
- **The ECB is unlikely to begin hiking rates until the QE programme has been completed in December. Thereafter, the timing of the first hike is likely to be dictated by the outlook for core inflation, which for now, is still very muted.**

GROWTH

Eurozone survey indicators are extremely elevated and suggest that GDP growth should continue to accelerate throughout 2017. On paper, the relationship between output and survey indicators suggests that GDP growth could approach 1% q/q (chart 1) with the annual rate accelerating towards 3% y/y by the end of the year. In turn, that would translate into an annual average growth rate of 2¼ to 2½. Yet the consensus and the ECB expect growth of 2% y/y or lower. This cautious outlook may reflect scepticism that the elevated surveys will actually filter through into the hard activity data, particularly in the context of the stop-start nature of the eurozone recovery thus far. We are more glass half-full and forecast an annual average growth rate of 2.2% y/y

Surveys aside, the outlook for the expenditure components of GDP is upbeat, although not stellar. In terms of the consumer, confidence is elevated and points to a bit more headroom. Meanwhile, real disposable income growth is relatively mediocre. The most upbeat parts of the growth outlook are investment and net trade. On the former, the elevated PMI survey suggests that investment growth could accelerate to a pace of 2% q/q or even higher. Meanwhile, net trade is likely to benefit from the combination of robust overseas demand growth and the relative weakness of the EUR exchange rate. More broadly, with the cloud of political risk lifting, there is one less headwind to growth.

On a country by country basis, clearly Germany is leading the charge. However, growth is broad-based, with Spain on track for a third consecutive year of growth in excess of 3% y/y.

INFLATION

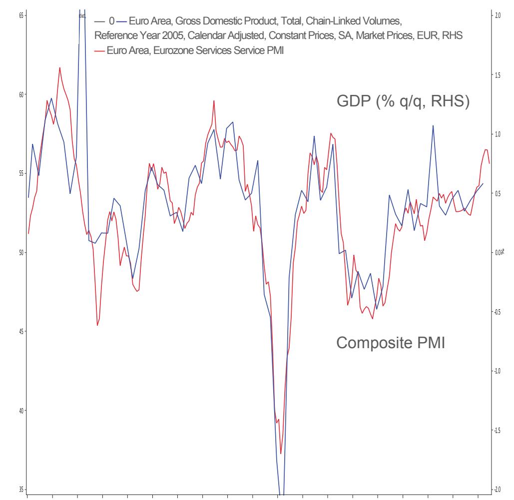
Headline inflation had rebounded strongly and briefly touched the 2% ECB target before subsequently falling back to below 1½% y/y. Much of the recent acceleration and subsequent fall-back in inflation was due to swings in road fuel price inflation. Base effects and higher oil prices boosted inflation by a full percentage point in the 6 months to February 2017. However, falling fuel prices have reversed half of that rise in the past 3 months alone. Over the remainder of this year, this component is likely to subtract a further 0.4–0.5% from inflation on the back of base effects (subject to further gyrations in the price of oil).

CONTACTS

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

Chart 1

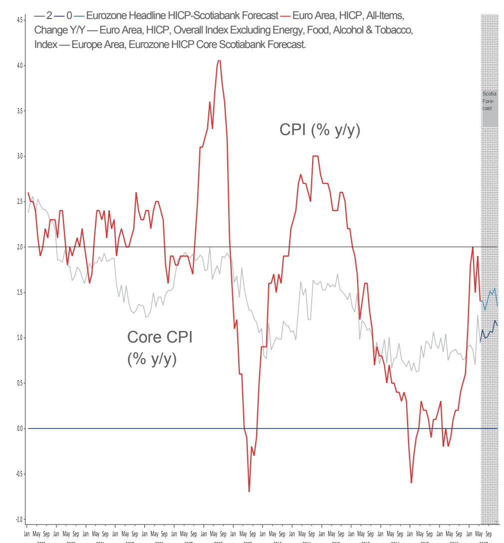
Eurozone Composite PMI vs GDP % q/q



Sources: Macrobond, Scotiabank.

Chart 2

Eurozone Inflation



Sources: Macrobond, Scotiabank.

The point is that with energy price inflation muted, eurozone inflation is likely to remain a substantial margin below the ECB's target unless there is sufficient upwards pressure from core inflation or food prices. Food price inflation is roughly where it should be, with no compelling signal in either direction. That leaves the direction of overall inflation dependent on core inflation.

With GDP growth now running above trend (which is probably around 1.1% y/y) the output gap and slack in the economy should be narrowing. Depending on how much slack there was in the first place, this either means that core inflation will fall more slowly, or could even gain altitude. Core inflation had been oscillating between 0.7 and 0.9% for close to eighteen months, with no concrete signs of accelerating yet. However, there has got to be a decent chance that if growth remains above potential, as we expect, then core inflation should gradually creep back above 1% y/y by the end of the year. Thereafter, core inflation is likely to continue rising gradually to around 1½% y/y by end-2018.

POLICY

Speculation has already begun that the ECB will soon embark on its exit strategy from the QE programme. To be clear, the ECB has committed to continue purchasing EUR60bn of government bonds per month until the end of 2017. First and foremost, we find speculation that the ECB could raise the Refi rate (i.e. tightening monetary policy) while the QE purchases are ongoing (i.e. loosening monetary policy) absurd. It would be like driving a car with the foot on the brake pedal and the accelerator pedal at the same time. Much more likely is the ECB will complete its programme of asset purchases, or even taper the pace of asset purchases, but not tighten policy while also loosening.

More generally, the ECB is likely to begin withdrawing policy accommodation (i.e. hiking rates) only once the Governing Council becomes confident that underlying inflationary pressures are sufficient to achieve overall inflation sustainably around 2% y/y. As such, we believe that two boxes need to be ticked. Firstly, above-trend GDP growth needs to persist well into 2018. Secondly, core inflation will need to rise consistently above 1% y/y by end-2017 and appear likely to remain on an upwards trajectory thereafter. If both of these conditions are met, then a rate hike around mid-2018 is plausible.

Political risk in the eurozone is fading, particularly following the French election result where the anti-EU Marine Le Pen fell well short of victory. While Germany and possibly Italy will go to the polls later in the year, we do not expect any major market or economic consequences of these.

Brazil

IS THERE REALLY LIGHT AT THE END OF THE TUNNEL?

- **Brazilian markets have rallied strongly over the past 18 months, based on expectations of reforms materializing, and the view that the economy has touched bottom.**
- **However, the political outlook has become cloudier as the Lava-Jato spreads, and the 2018 presidential elections near, which has in turn added uncertainty on the economic front.**
- **If reforms fall through, confidence will suffer, the BRL could sell off, which could in turn derail the BCB's efforts to support growth through rate cuts.**

Markets in Brazil rallied strongly for over 1.5 years, but more recently volatility has returned, alongside a more pessimistic tone. So, is the light at the end of the tunnel the exit from the country's turmoil, or a fast-moving train on a collision course? Our take is that it may be both. After spending the past couple of years in the midst of the deepest recession in the country's history, during which the economy was contracting at a 4%–8% pace, some positive growth signs are starting to emerge. Recent data suggest the economy is starting to move back towards flat (Q1 GDP was -0.4% y/y, and +1.0% q/q). In addition, after seeing inflation peak at 10.8% in 2015, it is back under 4%, giving the Brazilian Central Bank (BCB) room to cut rates, in order to give the economy some support (the SELIC rate has been cut from 14.25% to 10.25% over the past year).

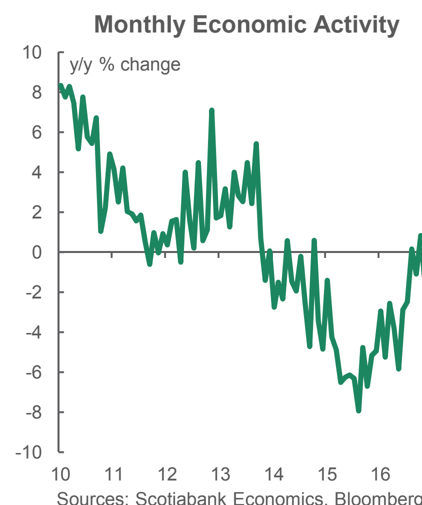
Although manufactured goods industrial production is today sitting at 2004 levels (see chart 2), it is encouragingly now moving sideways, rather than south. On the domestic demand side, the story is similar—although we still have some lingering concerns. Retail sales growth has finally turned positive (+1.9% y/y in April), after two years of negative prints. However, we remain somewhat concerned over household debt burdens, which could derail the recovery if confidence sours (triggered by potential worsening of political scandals or a reversal of rate cuts). As of the end of March (the latest data), Brazilian households were using 22.0% of their disposable income (i.e., after-tax income) to pay debt, which is lower than the 22.7% peak, but remains around the levels that we saw in both Spain and the US before the debt crisis.

On the external front, the news has also been reasonably good. After consistently posting current account surpluses in the 2003–2007 period, Brazil's current account swung into deficits in 2008. More concerning, the deficits widened to over 3% of GDP in 2012, and then stopped being fully funded by Foreign Direct Investment (FDI). The country's current account gap peaked in 2014 (-4.2% of GDP), and has since narrowed to a modest -1.3% of GDP—and is more than fully funded by FDI. As long as the growth rebound does not stall, and consumer confidence continues to improve, we expect the deficit to widen somewhat, but still within the 1%–2% of GDP range.

CONTACTS

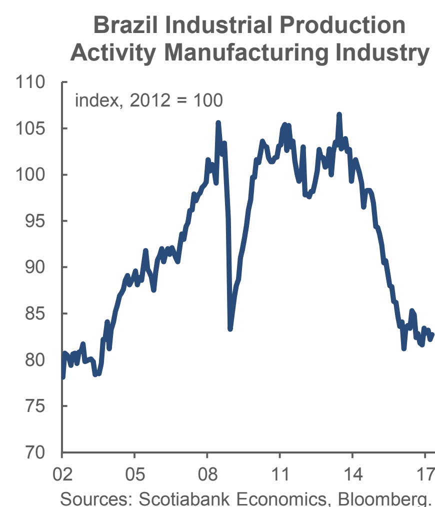
Eduardo Suárez, VP, Latin America Economics
52.55.9179.5174 (Mexico)
Scotiabank Economics
eduardo.suarez@scotiabank.com

Chart 1



Sources: Scotiabank Economics, Bloomberg.

Chart 2

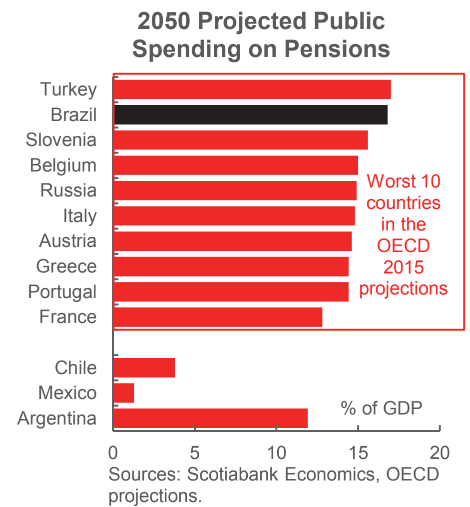


Sources: Scotiabank Economics, Bloomberg.

On the fiscal side, the Brazilian government has been making some progress in stabilizing public finances, cutting the public deficit from 10.2% of GDP in 2015, to an expected 9.1% in 2017—good, but not enough. In addition, gross public debt rose from 62% of GDP in 2008 to an expected 81% of GDP for 2017. Stabilizing the trajectory of public debt has proven a tough challenge, as spending rigidities, and a complicated political environment have combined to make the government's task quite difficult.

To help stabilize public finances, the government's efforts arguably have pension reform at their core. The recent pressure on Brazilian markets comes from the uncertainty over whether President Temer will be allowed to finish his term (following recent accusations and attempts to overturn the Presidential election), as well as whether the upswing in political uncertainty will derail the government's reform efforts. At the very least, it appears that reforms are likely to be delayed—risking overlapping with the presidential elections—which could ultimately derail them.

Chart 3



Sources: Scotiabank Economics, OECD projections.

Why is the Pension Reform so important? Brazil has one of the most challenging pension situations in the world, with annual pension payments forecast to top 15% of GDP on an annual basis by 2050 according to the OECD. We would argue Brazil's pension system is underfunded, and also, too generous. To put it in context, Brazilian men can currently retire at 56, and women at 53. If the reform is approved, the retirement age would be extended to 60 for women, and 65 for men. Even with those changes, the country's pensions would remain among the most generous in the OECD (chart 3). Under the current proposal, a man could retire at age 65—but receiving 96% of pre-retirement earnings!! In the average OECD country, a person can retire at age 65.5, receiving 53% of pre-retirement earnings. Recent polls suggest over 70% of voters disagree with the pension reform.

The current pension reform proposal is expected to save about US$190bn over the next 10 years, but its outlook is uncertain. If the pension bill falls through, there is a risk that investors' newfound confidence in Brazil will dissipate, sending the economy into a negative spiral as, among other factors, it could cause a sell-off in the BRL which could send inflation back higher, further pressuring consumers' already-stretched pockets by adding to their debt service burden—while simultaneously further complicating the fiscal situation.

Colombia

POLICY STIMULUS ACCELERATES, AS ECONOMY STALLS

- **Colombia's economy started the year flat-footed, with Q1 growth printing at a disappointing 1.1% y/y.**
- **With inflation rapidly converging to BanRep's target, the central bank is expected to continue easing policy to support growth.**
- **On the political front, even through May 2018 Presidential elections are likely to add some measure of uncertainty, near-term political clouds have cleared, as the spillover from the Lava-Jato scandals in Brazil seems to be contained in Colombia.**

The Colombian economy had a somewhat weaker-than-expected Q1, expanding at a meagre 1.1% y/y (the Colombia Central Bank, BanRep, had expected 1.3% y/y). Behind the weak print, was soft activity in mining, construction, and commercial activity (-9.4% y/y, -1.4% y/y, and -0.5% y/y, respectively). The latest industrial production print echoed the weakness we've seen in mining and construction, with the headline industrial production number for April coming in at -6.8% y/y. Industrial production has contracted in three of the four latest monthly releases, and it seems likely that the combination of steady, but lower, oil prices, alongside the shock to construction activity that the Lava-Jato presented is weighing on investment.

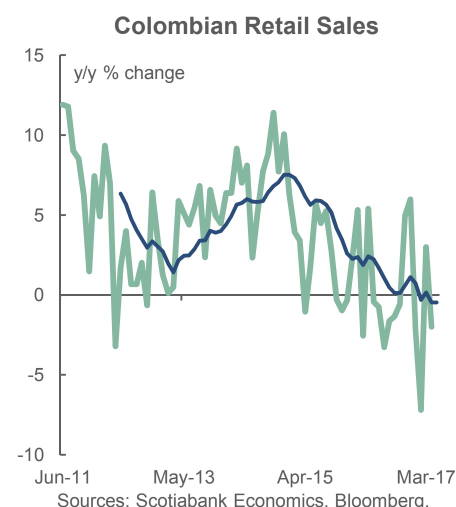
At the same time as output slows, we are seeing a softening in domestic demand, with retail sales recently going into somewhat of a nosedive (-2.0% y/y in April). The good news is that recent data on public spending seems more growth-supportive, while investment seems to have found a bottom (gross fixed capital formation was +0.1% y/y in Q1, after five quarters of contracting). On the flip side, exports continue to contract, posting their third quarterly decline (-3.6% y/y in Q1). The bottom line is that the economy remains weak, and our base case is that growth will print just under 2% for 2017 as a whole.

On a more positive note, as the economy slows, previously stubborn inflation is finally coming down, which is giving BanRep some room to cut interest rates in order to support the economy. After peaking at almost 9.0% in the summer of 2016, inflation is back at 4.4% (i.e., almost back within the target range). Consistent with rapidly falling inflation, and soft growth, BanRep's General Director, Juan Jose Echavarria, signaled his views are in line with the markets which look for 100bps of rate cuts over the next year. This dovish tone has been supported by at least two other members of BanRep's board—Ocampo and Cardenas. We agree with the view that the central bank will cut rates four times in the next 12 months (25bps each), and expect the cuts to be front-loaded, with our base case being that the overnight lending rate will be cut four times by year-end (to 5.25%), beginning with a cut on June 30th. Our take is that the main potential threat to the view of additional easing by BanRep is the Colombian peso (COP), which no longer looks clearly cheap (it's just over 1 standard deviation cheap), and could be vulnerable to a drop in oil prices. If the peso does weaken, it could tie the hands of the central bank, but that is not our base case.

CONTACTS

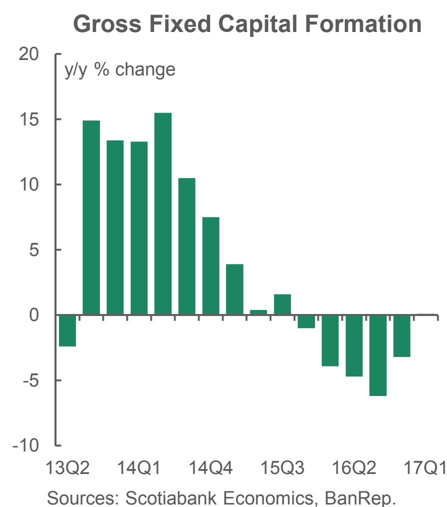
Eduardo Suárez, VP, Latin America Economics
52.55.9179.5174 (Mexico)
Scotiabank Economics
eduardo.suarez@scotiabank.com

Chart 1



Sources: Scotiabank Economics, Bloomberg.

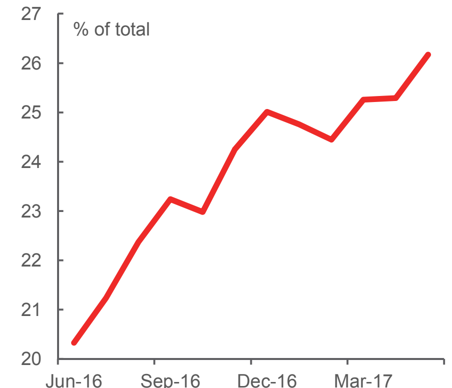
Chart 2



Sources: Scotiabank Economics, BanRep.

On the external front, the combination of slowing domestic demand, alongside a rebound in oil prices has helped compress the country's current account deficit, which now looks much healthier. After posting a very wide -6.4% of GDP deficit in 2015, we saw a narrowing of the deficit to -4.3% of GDP in 2016. Our main concern on the external accounts comes from capital flows. We have seen a very strong run for Colombian assets over the past 18 months, and TES local currency Colombian bonds are now trading 25bps –60bps tight to corresponding maturity m-bonos, which are both rated higher-rated and more liquid, and also have a larger "captive investor base" due to the m-bonos' inclusion in core market benchmarks. A potential issue is that if we were to have a shock that triggered a bout of risk aversion in global markets, Colombia could see outflows from local markets.

Chart 3



Sources: Scotiabank Economics, FinMin of Colombia.

On the political front, a potentially strong shock to the country's infrastructure building program seems to have been avoided, at least for now. In the initial stages of the Lava-Jato investigation in Colombia, it seemed that the Ruta del Sol II Highway project (one of the main infra projects in the country), could have been paralyzed for up to five years due to Lava-Jato related controversy. Thankfully, the risk of delays seems substantially less now, as the road appears to be in the process of being prepared for a new auction, without Odebrecht. This new turn could help restore confidence in infrastructure investment. In addition, initial reports that Lava-Jato could entangle President Santos, following allegations that Lava-Jato related money could have ended up financing his campaign, seem to have fallen through, reducing the risk that we could see the political scandal escalate into something more serious, as it did in Brazil and Peru. The next key date for the political calendar looks likely to be the 2018 presidential elections, which are scheduled for late May 2018.

Peru

AN ECONOMY DOMINATED BY POLITICS

- **Multiple shocks and politics have beset the economy.**
- **Future growth will hinge on public sector spending.**
- **No sign of an upturn in private investment (yet).**

Peru's economy has gone through three shocks in the last three quarters: 1) a contractionary fiscal policy at the end of 2016, the effects of which have lingered into this year, 2) the temporary but significant impact of the El Niño floods, and 3) the more prolonged effect of the Lava Jato events on infrastructure projects. This has all occurred during a period of extraordinary political tension between the government and opposition Congress which has brought three prominent cabinet members down since the Kuczynski regime began in July 2016.

So far, the markets seem fairly sanguine about political risks. However, within the country, economic concerns have taken a decidedly back seat to political issues. Although the political confrontation between Congress and the PPK administration supersedes Lava Jato, the noise created by Lava Jato has put all large infrastructure projects under political scrutiny. Two cabinet members: the Minister of Transportation, Martin Vizcarra, and the Minister of Finance, Alfredo Thorne, were pressured into resigning due to the political controversy surrounding the Chinchero (Cusco) airport project, even though the project is not linked to Lava Jato. Thorne was replaced as Finance Minister by the head of the cabinet, Fernando Zavala, who will have a dual responsibility. This may only be a temporary arrangement, even though Zavala has suggested otherwise. There is some likelihood that the government will change a number of cabinet members, probably around the end of July when President Kuczyinski is due to give the presidential yearly address to the nation. However, the key issue for the government is not economic policy but politics. Namely, will the cabinet be able to establish a working relationship with Congress, reform the convoluted institutional framework, and effectively advance a much needed infrastructure investment program.

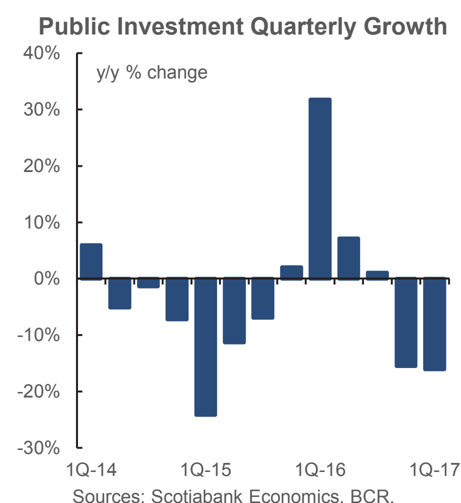
To complicate the political scene further, the decision regarding the release of ex-president Alberto Fujimori—a defining element in the relationship between the PPK regime and Congress—has again come to the forefront. Recent statements by spokespeople in both the government and Congress do not bode well.

Three shocks amidst political turbulence is a lot for an economy to endure. The immediate result is that GDP growth has been a paltry 1.6% y/y in the year-to-April. We expect a natural post-Niño rebound henceforth, however, the strength of the rebound will depend largely on government spending, which has been disappointing so far. Central Government investment has fallen over 20% in the year to May, despite resources and initial plans for a sharp increase. El Niño disruptions may be partially to blame, as well as political distractions, but difficulty in getting the government institutional spending apparatus to perform adequately

CONTACTS

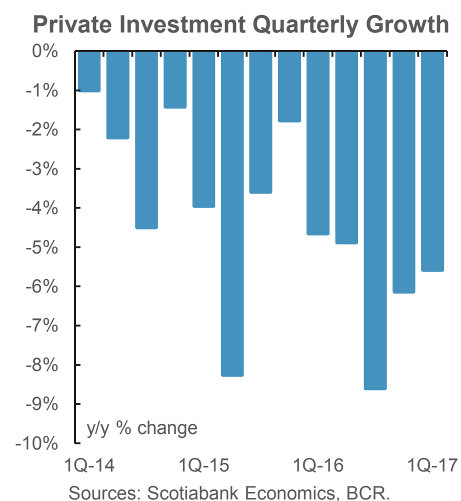
Guillermo Arbe
511.211.6052 (Peru)
Scotiabank Peru
guillermo.arbe@scotiabank.com.pe

Chart 1



Sources: Scotiabank Economics, BCR.

Chart 2



Sources: Scotiabank Economics, BCR.

also appears to be playing a part. Nonetheless, we expect an increase in spending, especially in post-Niño reconstruction, to commence late in the year, and gather force in 2018.

The private sector is another matter. Consumption growth has slowed to 3% or less, after growing consistently at 3.5% in the previous two years. There have been some positive signs for consumption in May, but a sustained turnaround will depend on investment starting to improve.

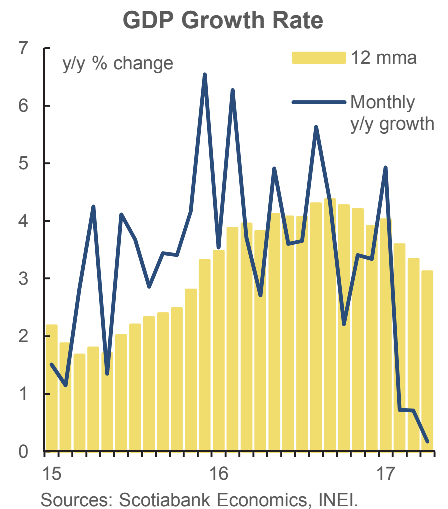
Private investment is well into its fourth year of negative growth with no indication of having reached an inflexion point. While the political environment is not helping business confidence, more fundamental factors are also at play, including excess capacity in industries that cater to domestic demand, and persistent overregulation.

As a result of weak domestic demand, GDP growth has been more linked to natural resources: metals, fishing and agro-industrial output. Except for the smaller agro-industrial sector, in which robust growth is expected to continue, natural resource growth will taper going forward and, in the second half of the year, growth will depend on a pick-up in domestic demand. Thus, the next two quarters will be telling. The third quarter will tell us how resilient growth is without the contribution of natural resource production. The fourth quarter will tell us how aggressive the government will be in its public investment plans.

The Central Bank has signaled that monetary policy will continue to be moderately supportive of growth, which means that further decreases in its reference rate, currently at 4.0% (the CB did not reduce the rate in June) are possible, as well as lower reserve requirements. Inflation, at 3.0%, annual, has declined sharply in the last two months, as food distribution normalized after El Niño. We agree with the Central Bank in expecting inflation to continue falling well within the CB target range (1%–3%), giving the CB room for further monetary loosening. This will be moderate, however, because the Central Bank, with an eye on the FX rate, doesn't seem comfortable reducing rates aggressively when the Federal Reserve is raising its rates.

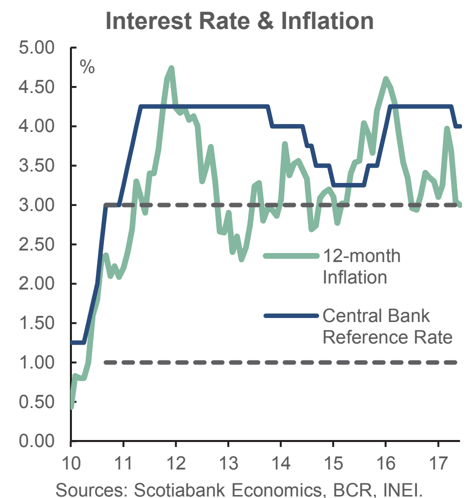
Price stability includes the FX market. With external accounts strengthening more than expected, we ratify our year-end FX forecast of S/ 3.25.

Chart 3



Sources: Scotiabank Economics, INEI.

Chart 4



Sources: Scotiabank Economics, BCR, INEI.

Chile

ANOTHER DOWNGRADE TO OUR FORECAST

The negative risk to our forecast for the first half of the year unfortunately materialized. The slow trend of growth was hit by a set of adverse conditions, the most important of which being the strike in a major copper mine. Even accounting for this, the recovery was weaker than expected and forces us to trim our forecast for the year to 1.6%, with downside risks remaining. Considering the meagre growth so far, achieving this forecast requires a strong recovery in the second half of the year. Support from monetary policy should contribute to stronger growth of 2.6% in 2018. It should be noted this growth would be just a tad below the potential estimated (not higher than 3%).

DOMESTIC DEMAND STAYS FEEBLE

Construction investment is much weaker than we had thought, though investment in machinery and equipment is recovering slowly. As said many times, at the current stage of the cycle, the anticipated recovery in investment is more closely related to business confidence than to the cost of financing. Accordingly, our forecast for investment was revised to -0.3% for the current year, though the recovery for 2018 is estimated at 2.2%. Inventories are rising, as anticipated, and this is expected to continue, since inventory levels remain below levels from four years ago. On the positive side, indices of expectations, both business and consumer, though still in the pessimistic zone, have been showing a moderate recovery. Likely, this improvement should continue because some critical factors in the confidence functions are expected to support them: tamed inflation and lower domestic and foreign risks.

LABOUR MARKET, FISCAL POLICY AND FOREIGN SECTOR

The unemployment rate has been rising and it should continue to do so given that it lags the cycle, some moderation in the rapid pace of growth in self-employment is expected, and the labour law reform deters companies from hiring (some of them declare to be increasing investment in equipment to avoid labour troubles). Though fiscal spending grew at a very fast rate in the first quarter, it is likely to be capped for the rest of the year. The severe warning coming from two rating agencies now seems a foregone fact: the low rate of growth of fiscal income due to the paltry growth of the economy, and despite the huge tax reform, will force a downgrade of the risk rating, though the investment grade will be retained. Likely, this negative event is already priced in the sovereign risk premium. Fortunately, foreign accounts look in order and perspectives remain relatively solid. For example, the current account deficit is expected to reach 1.5% of GDP in 2017.

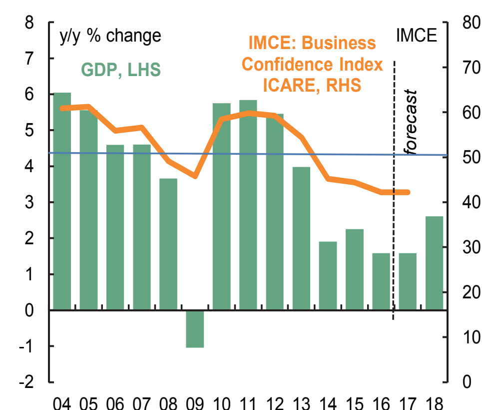
EXCHANGE RATE, INFLATION AND MONETARY POLICY ALL RATHER STABLE

As expected, and it has been the case since mid-2016, the domestic exchange rate (USDCLP) has been trading within a relatively narrow range, between 640 and 680. Inflation remains below the long term target, but should rise going forward. We forecast inflation of 2.8% in 2017, rising to 3.1% in 2018. The Central

CONTACTS

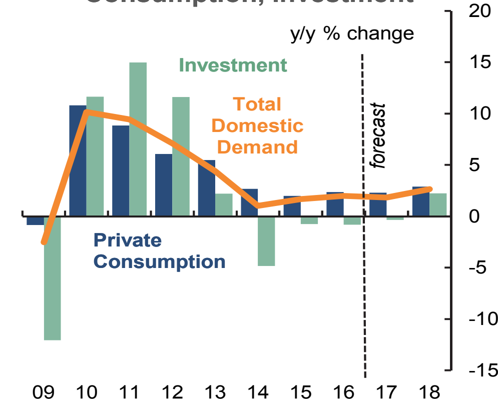
Benjamin Sierra
56.2.2619.4974 (Chile)
Scotiabank Chile
benjamin.sierra@scotiabank.cl

Chart 1



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

Chart 2



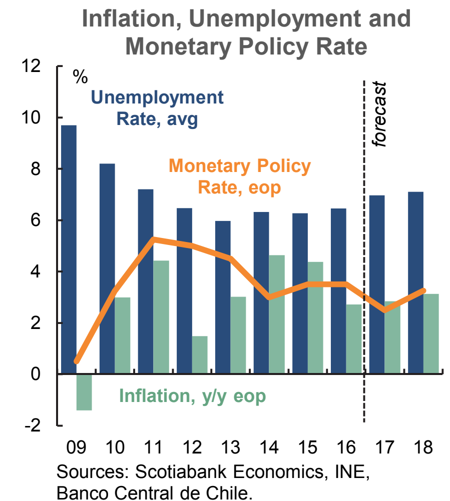
Source: Scotiabank Economics, Banco Central de Chile.

Bank accelerated cuts to the policy rate, leaving the rate at 2.5% last May with a neutral bias. We anticipate the rate will remain there for the rest of the year. In general, interest rates are at historically low levels, but the expansion of credit remains very limited. As inflation rises in 2018, monetary policy will need to tighten, likely around the middle of 2018.

ELECTORAL OUTCOMES REMAIN KEY

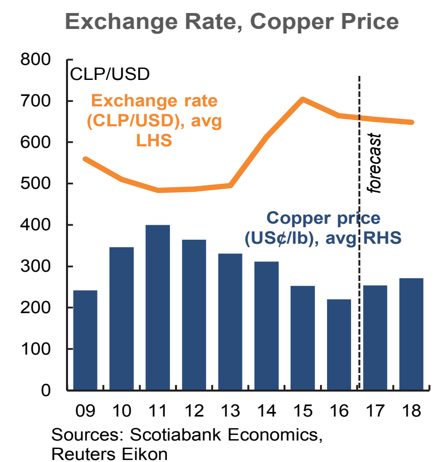
The next general election, for which the first presidential round will take place on November 19th will be faced by a divided centre-left ruling coalition. So far, the favourites for the very likely second ballot (on December 17th) continue to be the former President Sebastián Piñera (opposition, rather pro-growth) and the Senator Alejandro Guillier (somewhat aligned with the ending Government). Considering the current conditions, the probability seems higher for Mr. Piñera, but there are many factors that may have a bearing on the final result, abstention levels being the most notable (in the municipal election last year it was 65%). Though Chile has not faced the same scandals as other Latin American countries, most Chileans feel political disaffection (especially towards Congress and parties, which bear a very low support). The winner will likely have to look for support in both chambers to accomplish his program. Financial markets are probably considering this scenario to some extent, but most surveys suggest that investors in the real sector still remain on the sidelines, preferring "to pay to see" how the candidates will face the challenge in the final track. The outlook might be clearer following the primary elections (July 2nd) onwards, but even then will be far from being a risk-free political outlook.

Chart 3



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

Chart 4



Sources: Scotiabank Economics, Reuters Eikon

China

- **Public spending spree helps the Chinese economy to meet its official growth target in 2017.**
- **China will continue to transition toward a more sustainable economic growth path in 2018.**
- **Monetary authorities continue to balance between supporting economic growth and reducing financial risks.**

GROWTH SLOWDOWN TOWARDS SUSTAINABLE RATES

The Chinese economy is showing early signs of resumed growth deceleration after a period of stimulus-induced strength. Over the past few quarters, economic activity has been underpinned by massive public outlays in fixed assets (chart 1), particularly in infrastructure. Now, due to a high base the government will find it challenging to maintain such expenditure growth (23% y/y in the first half of 2016), which will likely lead to a loss of momentum in the broader economy.

The slowdown is becoming evident in the industrial sector, as implied by somewhat softer data on high-frequency indicators such as steel output and electricity consumption. Nevertheless, other areas of the economy seem to be maintaining their impetus; a pick-up in global demand is supporting Chinese exporters, while a stronger consumer is buttressing growth in retail sales and the services sector more broadly (chart 2). With this trend, the Chinese economy continues to become increasingly dependent on household spending and the services sector, which is characteristic of more advanced economies. In the first quarter of 2017, the services sector accounted for 56% of China's output, leaving the industrial sector's 39% share far behind.

We expect that the Chinese government will continue its sizeable fiscal injections to keep the economy's growth trajectory in line with requirements for social harmony. Regardless, the waning stimulatory impact of fiscal spending will cause real GDP growth to decelerate over the coming quarters after output expanded by 6.9% y/y in the first three months of 2017. Still, China is well positioned to meet the official growth target of "around 6.5%" in 2017; we expect output to expand by 6.6% this year. In 2018, the economy will likely continue its transition toward a more sustainable growth trajectory, with real GDP expected to advance by 6.1% y/y.

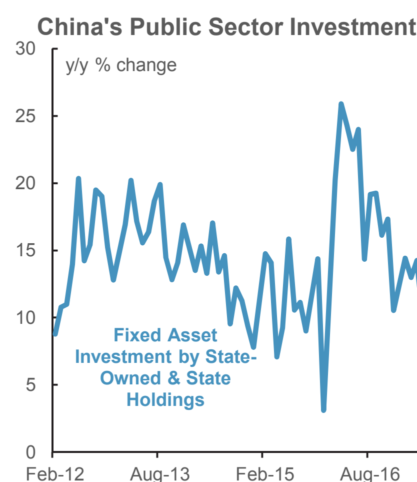
NEUTRAL MONETARY POLICY AMID REGULATORY OVERHAUL

The People's Bank of China (PBoC) will likely maintain the current monetary policy stance unchanged over the coming months given the decelerating forces the Chinese economy is facing. The 7-day reverse repo rate, which can be interpreted as the PBoC's de-facto policy rate, is now 2.45%; it was raised by 10 basis points in February and March in order to encourage deleveraging while avoiding the risk of an abrupt economic slowdown. Meanwhile, the one-year loan and deposit rates have been kept at 4.35% and 1.50%, respectively, since October 2015. China's inflationary pressures are expected to remain contained, allowing for the maintenance of growth-supportive monetary conditions. Consumer price inflation is

CONTACTS

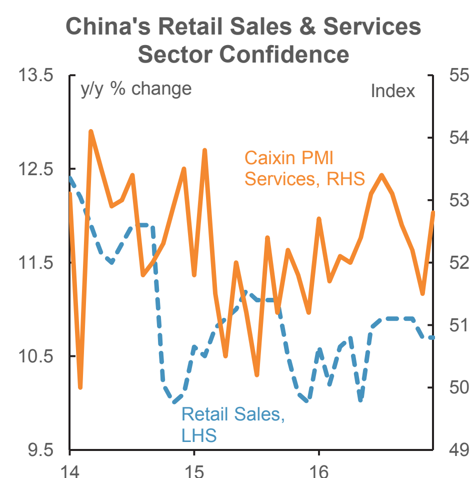
Tuuli McCully
65.6305.8313 (Singapore)
Scotiabank Economics
tuuli.mccully@scotiabank.com

Chart 1



Sources: Scotiabank Economics, Bloomberg.

Chart 2



Sources: Scotiabank Economics, Bloomberg.

currently hovering around 1½% y/y. We expect price gains to accelerate only gradually over the course of the year, with the headline inflation rate closing 2017 at 2.0% y/y.

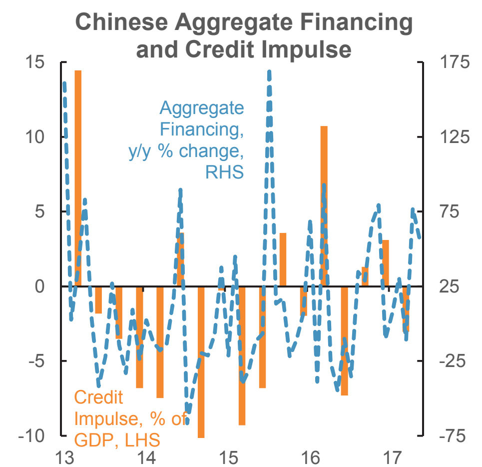
The PBoC will continue to implement "prudent and neutral" monetary policy, according to official statements. The stance reflects the fact that the preservation of economic and financial stability is policymakers' priority ahead of the 19th National Congress of the Communist Party of China, which will be held at the end of this year. The central bank recently highlighted the authorities' commitment to keeping liquidity stable and focusing on the elimination of financial risks. Increased attention is given to non-performing assets, high corporate leverage, bond defaults, and shadow banking. Indeed, the country's banking regulator has announced an implementation of almost 50 legislative programs for this year that target the banking sector with the aim of improving risk management, promoting gradual deleveraging, and managing troubled loans in the economy.

Chinese authorities' efforts in financial deleveraging and increased supervision are reflected in the recent slowdown in M2 money supply growth (to 9.6% y/y in May from 11.3% early this year). While aggregate financing in the economy continues to grow rapidly (by over 40% y/y in May in 3-month moving average terms), the economy's credit impulse—change in new credit as a share of GDP—dropped back to negative territory in the early months of this year (chart 3). As this metric is a leading indicator for future real GDP expansion, it suggests that China's output growth will slow over the coming quarters. Against this backdrop, China's high debt burden—centered on corporations—is a substantial element of risk in the country's longer term outlook, triggering concerns regarding the banking sector's asset quality.

During the ongoing regulatory storm in China, the real estate sector has been another focus area for policymakers. Various restrictions on mortgages and home purchases have been implemented in recent months in order to limit skyrocketing house prices, particularly in top-tier cities. For the time being, China's housing boom continues with new apartments in virtually all major cities (in 69 out of 70 cities in May) recording annual price gains. Nevertheless, local governments' measures to cool the heated market seem to be working, as house price inflation has slowed markedly in Tier-1 and Tier-2 cities (chart 4). Meanwhile, price gains have accelerated in lower-tier cities.

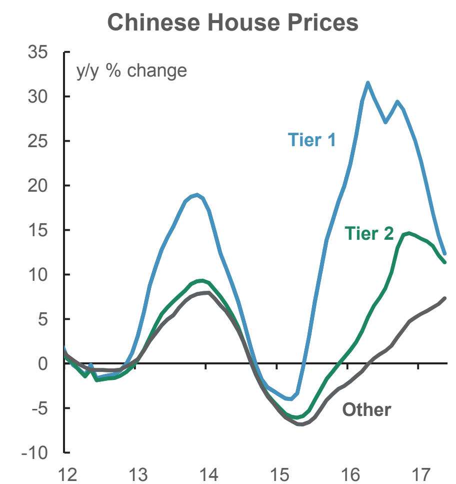
We assess that near-term developments in the Chinese housing market warrant close monitoring given that the real estate sector accounts for a large part of the economy and developers are among the most leveraged corporations in the country. Nevertheless, we also point out that demand for real estate in China will not vanish rapidly on the back of a rather limited number of attractive investment alternatives domestically and difficulties in asset diversification abroad due to China's capital controls.

Chart 3



Sources: Scotiabank Economics, Bloomberg, The People's Bank of China.

Chart 4



Sources: Scotiabank Economics, Bloomberg.

Japan

- **Strengthened economic growth offers opportunity for reforms.**
- **Subdued wage gains keep inflationary pressures at bay.**

CONTACTS

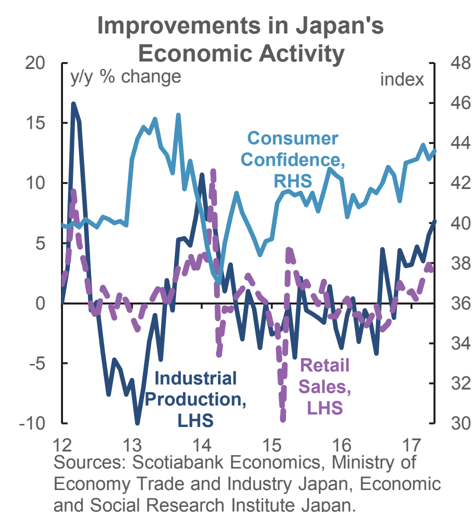
Tuuli McCully
65.6305.8313 (Singapore)
Scotiabank Economics
tuuli.mccully@scotiabank.com

STRONG GDP GROWTH BY JAPANESE STANDARDS

The Japanese economy is gaining strength, at least temporarily. The external sector is a key growth motor, responding to firming global demand. In addition, activity has recently become more broadly based with consumer spending and fixed investment providing additional support to the economy's momentum, underpinned by tight labour market conditions and improving corporate profits. Indeed, consumer confidence is showing signs of further strengthening (chart 1) while the retail sales and industrial production indices have reached their highest levels since the Global Financial Crisis.

Japan's real GDP grew by 0.3% q/q (non-annualized) and 1.3% y/y in the first quarter of 2017. We forecast that the country's output will advance by 1.2% in 2017 as a whole—above the estimated potential growth of less than ½% y/y—supported by stimulative fiscal and monetary policies. Nevertheless, the impact of the former will start fading as we approach 2018. Without an additional fiscal boost, Japan's growth is set to decelerate to 0.8% y/y in 2018. Given the limited space for further policy loosening on both the fiscal and monetary fronts and the transitory nature of such stimulus, the economy needs productivity-boosting structural reforms in order to sustain higher real GDP gains over the medium-term. Given the current solid, yet potentially short-lived, economic momentum, we believe that now would be the ideal time for such reform implementation.

Chart 1



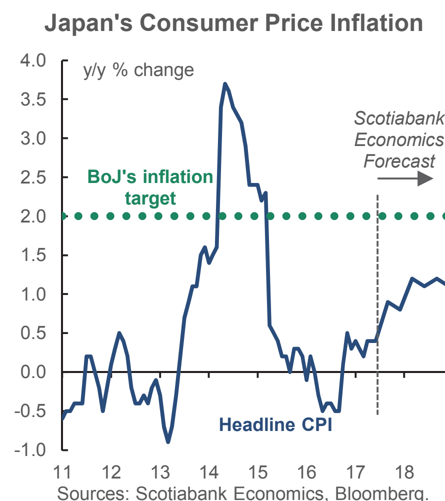
Sources: Scotiabank Economics, Ministry of Economy Trade and Industry Japan, Economic and Social Research Institute Japan.

LOOSE MONETARY POLICY AMID LOW INFLATION

The Bank of Japan (BoJ) is expected to keep the ultra-accommodative monetary policy stance unchanged over the coming quarters. Following its most recent policy meeting in mid-June, the central bank sounded somewhat more upbeat about the economy. Regardless, Governor Haruhiko Kuroda dismissed any premature talk about scaling back the BoJ's stimulus program; he emphasized that the central bank will debate an exit strategy only after the 2% y/y inflation target has been achieved and inflation stays at the target in a stable manner. With the headline inflation rate currently hovering at ½% y/y (chart 2), it is too early to signal any intentions of withdrawing monetary stimulus.

We do not anticipate the BoJ's 2% y/y inflation target to be met in the foreseeable future given subdued wage growth. Japan's headline inflation rate will likely climb to only 1.1% y/y by end-2018. Despite Japan's tight labour market conditions, real wages declined by 0.1% y/y on average in the first four months of 2017. Labour market rigidities are the key element holding back wage gains; employees' bargaining power is limited because of companies' preference for hiring part-time and contract workers in order to circumvent high employment protection costs related to regular workers. While the government has announced initiatives to address some of the labour market issues, it will take time before any such reforms translate to higher wage gains and demand-driven inflationary pressures.

Chart 2



Sources: Scotiabank Economics, Bloomberg.

India

- **Weaker inflation and real GDP growth trigger forecast revisions.**
- **Reserve Bank of India expected to respond with further stimulus.**

CONTACTS

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

SUBDUED ECONOMIC GROWTH AND BENIGN INFLATION

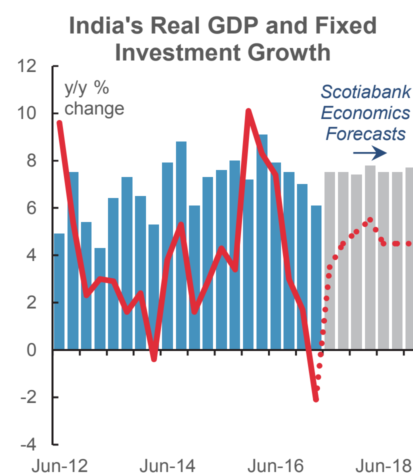
The Indian economy disappointed in the first three months of 2017 on the back of a cash shortage that followed the government's currency exchange initiative. Real GDP increased by 6.1% y/y (chart 1)—significantly less than the 2016 growth of 7.6%—as construction, financial and professional services, and real estate were adversely affected. Economic growth is driven by household spending—on the back of India's rapidly expanding middle class and rising disposable incomes—while a contraction in fixed investment in early 2017 highlights a substantial area of weakness in India's economic outlook. We have been anticipating a pick-up in investment over the coming quarters due to the government's efforts to improve the country's business environment, yet it is becoming evident that the recovery is taking longer to materialize. In our view, one of the key reasons for such muted investment performance is the burden of bad debt in the Indian banking system that has yet to be cleared. We have made a downward revision to India's real GDP growth forecast, and now expect output to advance by 7.1% in 2017 (compared with a prior forecast of 7.5%).

India's inflationary pressures remain weak. Consumer price inflation has eased to close to 2% y/y—a very low inflation rate by Indian standards and near the lower boundary of the Reserve Bank of India's (RBI) inflation target of 4% ± 2% y/y (chart 2). The deceleration reflects muted demand-driven pressures following the government's recent demonetization initiative, lower domestic petrol and diesel prices, as well as weaker food inflation that is a result of improved food management. Furthermore, food price gains should remain contained over the coming months given that rainfall of the southwest monsoon (June–September) is expected to be in "normal" category. Accordingly, we have revised our inflation forecast for India, and expect the headline rate to close the calendar year 2017 at 4.2% y/y (compared with a prior forecast of 5.5%).

FURTHER MONETARY STIMULUS IN SIGHT

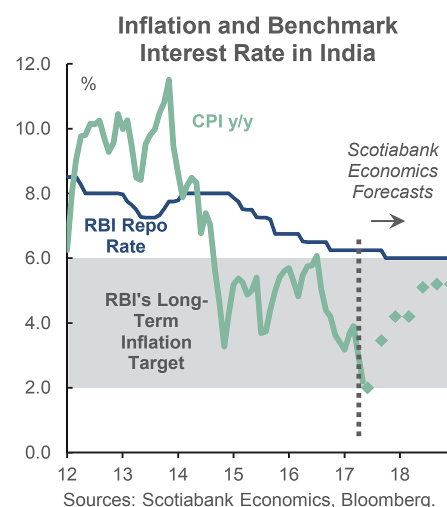
Low inflation and disappointing economic growth momentum give the RBI's Monetary Policy Committee (MPC) a reason to consider another benchmark interest rate cut. The next policy review is scheduled for August 1–2, followed by another assessment on October 3–4. We have revised our RBI interest rate forecast and now expect the benchmark repo rate to be cut by 25 basis points to 6.0% in October. In our view, awaiting the July CPI data (to be released in mid-August) will be the key reason for not reducing the policy rate in early-August; the nationwide Goods and Services Tax (GST) will be rolled out on July 1. While the RBI does not expect any material direct inflationary impact stemming from the tax, it remains to be seen whether Indian firms will take the opportunity to raise prices in July under the cover of the GST. Furthermore, April–June real GDP data will also be available at the October MPC meeting, which will help the RBI assess how quickly the economy is recovering from the early-2017 soft spot.

Chart 1



Sources: Scotiabank Economics, Bloomberg.

Chart 2



Sources: Scotiabank Economics, Bloomberg.

Australia

- **Australian economic growth will remain near potential through 2018.**
- **Domestic demand is a key source of medium-term growth.**
- **Labour and housing markets as well as accommodative monetary conditions support the Australian consumer.**

The Australian economy continues performing strongly compared with other advanced economies, despite the fact that it is in the midst of a structural change following years of mining investment-driven growth. We expect the country's real GDP to grow by 2.4% this year (chart 1); a modest pick-up to 2.7% is expected in 2018 on the back of momentum becoming more broadly-based. As such, Australia's economic growth continues to be in line with the country's estimated potential growth of around 2½% y/y through 2018.

A muted price outlook for Australia's key export commodities (iron ore, coal and LNG) will dampen the country's external sector prospects. Nevertheless, higher resource export volumes—reflecting project completions—will provide a welcome, yet transitory, boost to export growth. On the domestic demand front, government spending will remain cautious given the fact that the nation is at risk of losing its top sovereign credit rating status. Growth in fixed investment will continue to be limited by a high base following the recent mining investment boom. Nevertheless, non-mining investment, particularly construction, is expected to gather momentum over the coming quarters. Such a pick-up would place the Australian economy on a more balanced footing, as currently real GDP growth is heavily dependent on household spending. Australian consumers' purse strings will be affected by three key factors that warrant close monitoring: 1) the labour market; 2) the housing market; and 3) domestic interest rates. We will discuss these factors in more detail below.

IMPROVING LABOUR MARKET UNDERPINS CONSUMER SPENDING

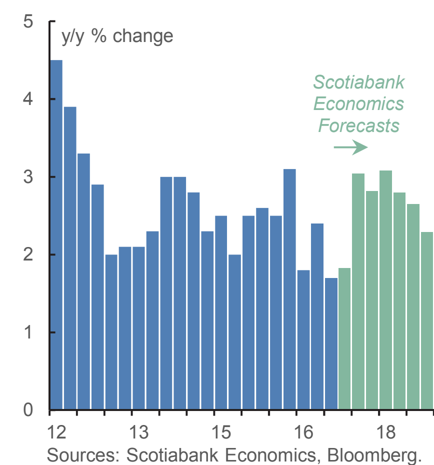
Australian policymakers are closely monitoring the country's labour market developments to better understand the future financial health of the country's consumers. Employment gains in recent quarters have been dominated by part-time jobs at the expense of full-time work (chart 2); in 2016 net employment gains were fully driven by part-time jobs. The trend has fed increasing underemployment (chart 3) and muted wage gains (earnings grew by 1.9% y/y in the first quarter, slightly below the nation's 2.1% inflation rate), which have translated to concerns regarding the sustainability of Australia's consumer-driven economic growth outlook.

Promising signs have emerged in recent months as full-time jobs have begun to account for a more significant share of employment gains. In fact, over the past three months (March–May) 80% of employment gains have come from full-time jobs, pointing to a reversal to the 2016 trend. Additionally, despite an increase in labour force participation, Australia's unemployment rate dropped to 5.5% in May. The Reserve Bank of Australia (RBA) estimates that the economy's NAIRU (non-accelerating inflation rate of unemployment) is around 5%, implying that

CONTACTS

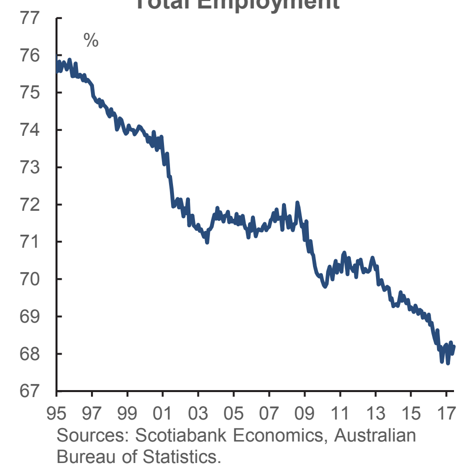
Tuuli McCully
65.6305.8313 (Singapore)
Scotiabank Economics
tuuli.mccully@scotiabank.com

Chart 1



Sources: Scotiabank Economics, Bloomberg.

Chart 2



Sources: Scotiabank Economics, Australian Bureau of Statistics.

Australia's labour market slack is gradually diminishing. Should the recent developments continue over the coming months, the economy should see a pick-up in wage growth, placing the Australian consumer on a stronger footing.

BUOYANT HOUSING MARKET SUPPORTS CONFIDENCE, YET RISKS ARE RISING

Beyond the labour market, house price developments are another key factor impacting household spending due to their significant wealth effects and impact on consumer confidence. The heated real estate market in certain cities has been an area of concern for the RBA's policymakers. Underpinned by the low interest rate environment, house prices have risen substantially (chart 4) along with household indebtedness. Residential real estate prices have increased by 44% over the past five years, yet regional variations are large; in Sydney, prices have surged more than 70% while Perth is up by only 5% as it is currently experiencing a housing downturn. Household debt currently hovers close to 190% of gross disposable income—an all-time high—raising concerns about Australian consumers' ability to respond to potential economic shocks in the future. Nevertheless, another look at household balance sheets reveals that while debt has increased by 32% over the past five years, household assets have risen even faster, by 51%, leading to significantly higher household net worth. That said, an asset price correction could quickly erode household net worth as liabilities would remain unchanged, explaining policymakers' attention on the issue.

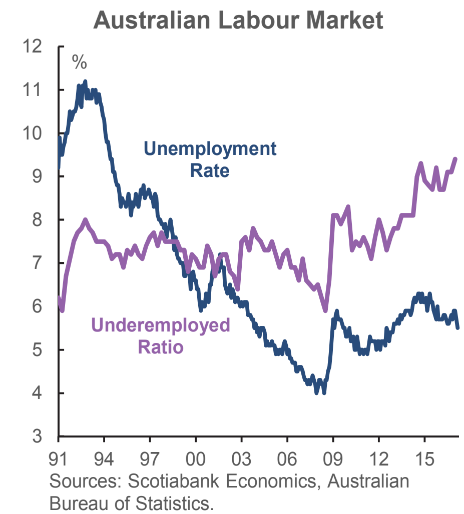
Given the fact that housing market imbalances and associated risks vary substantially across the country, the RBA has not been eager to consider a higher benchmark interest rate as a way to address them. Instead, the central bank has implemented supervisory measures to strengthen lending standards and instill a more cautious attitude among lenders. So far, growth in outstanding mortgages has moderated only slightly to 6% y/y in the first quarter of 2017 from 6.8% a year earlier. However, following the RBA's June 6 monetary policy meeting, Governor Philip Lowe suggested that house price pressures are starting to ease, while additional supply of apartments in the major eastern cities will help the real estate market move to a more balanced position.

LOW INTEREST RATES TO REMAIN FOR AN EXTENDED PERIOD OF TIME

Australia's current low interest rate environment is an important factor underpinning consumer spending and fixed investment. In order to support domestic demand during the economy's structural transition, we anticipate that the RBA will not change its monetary policy stance over the coming quarters. In our view, the benchmark interest rate will be left at 1.5% until the second half of 2018 when a cautious monetary tightening phase will likely commence.

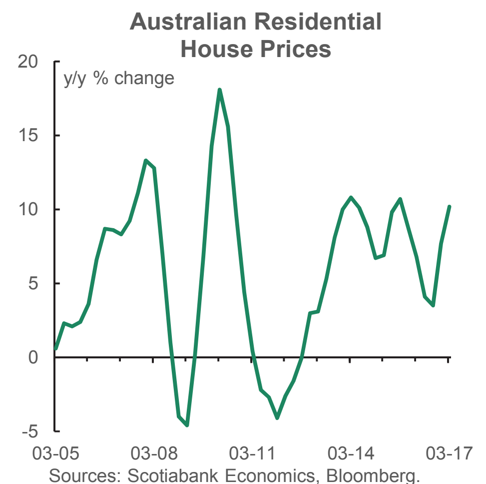
Reflecting muted wage gains, inflationary pressures remain contained in Australia. The country's headline inflation rate climbed to 2.1% y/y in the first quarter of 2017 (chart 5) from 1.5% at end-2016, pushing inflation into the RBA 2–3% target range. Nevertheless, the acceleration was not a result of strong demand-driven price pressures but reflected the base effect stemming from very low commodity prices a year earlier. We assess that slack in the Australian labour market will continue to keep wage increases and core inflation low. Accordingly, we forecast that headline inflation will close the year at 2.0% y/y and continue to hover near the lower-end of the central bank's target band through 2018.

Chart 3



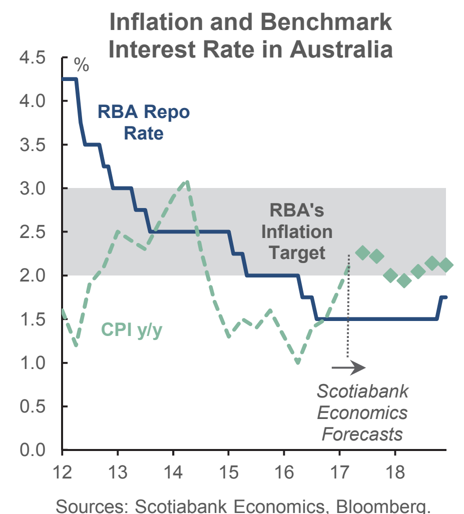
Sources: Scotiabank Economics, Australian Bureau of Statistics.

Chart 4



Sources: Scotiabank Economics, Bloomberg.

Chart 5



Sources: Scotiabank Economics, Bloomberg.

Commodities

- **The second quarter of 2017 wasn't great for commodities: crude oil prices fell to their lowest level of the year in June and virtually all industrial metals posted quarter-on-quarter losses.**
- **Some of these declines reflected a true deterioration of fundamentals, as in the case of nickel, but we believe that the fallback in oil is an overreaction to an admittedly uninspiring string of high-frequency data.**
- **We remain optimistic, however, and see most commodities gaining through 2017 and 2018 on the back of a global economy that continues to strengthen as well as a gradual reversal of US dollar strength.**

OIL & GAS

Oil prices fell to their lowest level of the year, below $43/bbl (WTI), in June and the market is plagued by uncertainty. An uncertain market prioritizes the here and now, and the US Department of Energy's weekly data release on inventories and domestic production is driving spot price formation. These weekly data turned bearish in late May and sent prices tumbling, but only after fifteen weeks of counter-seasonal inventory draws that pointed to tightening physical balances (chart 1). **We remain committed to our view that oil market fundamentals will tighten through 2018, though we have lowered our WTI price forecast marginally to reflect second quarter weakness, now at $51/bbl in 2017 and $53/bbl in 2018**.

First, it is important to provide a bit of context on the buildup of US petroleum inventories that sparked crude's recent sell-off, which we believe to be the result of a transitory glut of light sweet crude in the Atlantic basin. Strong production growth in the US shale patch was coupled with sudden supply gains from Libya and Nigeria, both of which are exempt from OPEC+[1] cuts and export light sweet crude into the Atlantic. Demand growth also slowed on the back of lingering demonetization headwinds in India as well as seasonal maintenance and low utilization rates in China's independent refining sector. The surge in Atlantic production had nowhere to go and thus naturally backed up into the cheapest storage available: US tank farms.

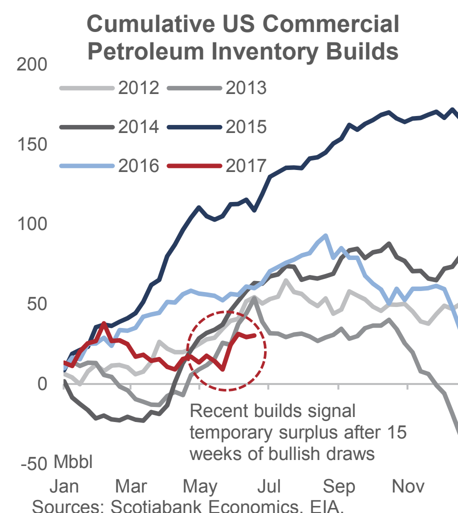
Importantly, we believe that this mini-glut will be short-lived and that inventories will resume their decline through the latter half of the year (chart 2). Global demand growth remains firm and is accelerating on the back of India and China's recovery. OPEC+ is expected to maintain production discipline, leaving the supply burden to the rest of the world. Outside OPEC+, the US shale patch will provide the lion's share of supply growth while other nations will muddle through, feeling the brunt of the roughly trillion-dollar post-crash reduction in planned global industry investment between 2015 and 2020.

[1] OPEC+ refers to the larger informal group of OPEC and non-OPEC producers that agreed to collectively reduce oil production by 1.8 Mbpd in a November supply deal. Output cuts were relative to October 2016 levels, with OPEC contributing 1.2 Mbpd and non-OPEC countries including Russia, Kazakhstan, and Oman agreeing to hold back the remaining 0.6 Mbpd.

CONTACTS

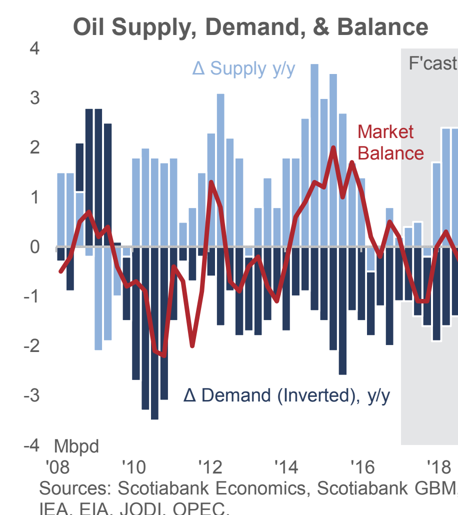
Rory Johnston
416.862.3908
Scotiabank Economics
rory.johnston@scotiabank.com

Chart 1



Sources: Scotiabank Economics, EIA.

Chart 2



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

From here, the key factors that will determine our escape path out of the current glut will be the performance of US shale, the pace of OPEC+'s return to the market in 2018, the volatility of Libyan and Nigerian production, as well as the fortune of non-OPEC supply outside the US.

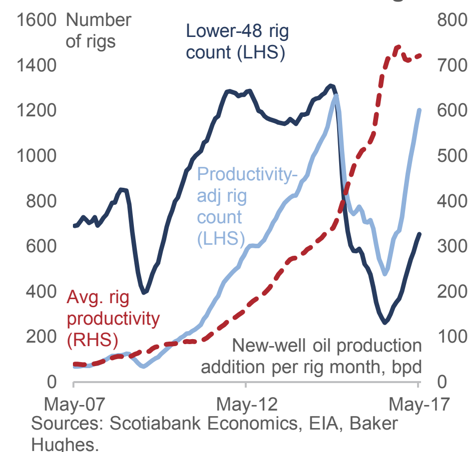
Last quarter, we adopted what we called an "ultra-aggressive" outlook for the US shale patch. That forecast saw production growth exceeding 1 Mbpd y/y by the end of 2017 and maintaining that pace through 2018 and beyond. That's a lot of crude and a rarified pace of growth, matched only in the industry's history by the shale patch's pre-crash climb. This view was aggressive when first communicated but has since become consensus, establishing an effective near-term WTI price ceiling around $55/bbl. However, we are beginning to question the longevity of 1+ Mbpd y/y production growth in the US shale patch. Rig productivity has plateaued as drilling spreads to less prolific acreage (chart 3), putting the onus on an ever-rising rig count, which itself will likely feel the pressure of the recent price decline (chart 4). US shale producers have proven that they can adapt to tough times and we see US growth ending 2017 on a high note, but sub-$55/bbl prices are likely to stunt 2018 gains.

OPEC+ compliance with the supply reduction agreement remains high and we expect continued production discipline through the March 2018 extension. OPEC is then likely to become more data-dependent, carefully monitoring inventory and other fundamental data to determine the pace at which the market can accommodate a gradual return of restrained output. The more immediate concern is Libya and Nigeria, which were exempted from the agreement due to internal militancy challenges and have seen production rebound considerably in the last month. In Libya, production is up to roughly 900 kbpd, its highest level since 2013, from less than 600 in April and less than 300 last summer as a handful of major fields reopen and some contractor disputes are resolved. Similarly, Nigeria has reopened its Forcados pipeline that was offline for nearly 500 days due to militant attacks, upping shipments by nearly 300 kbpd. Libyan and Nigerian production has been extremely volatile, however, and these barrels may be lost as abruptly as they returned.

The outlook for non-OPEC producers outside the US has improved somewhat given progress in Brazil's offshore sub-salt developments, the further ramp-up of Kazakhstan's massive Kashagan field, and the continued rollout of Canadian oil sands capacity. However, these current growth centres will soon slow and output continues to contract in large producers like China and Mexico. We believe that production in this segment will suffer the brunt of the reduction in investment since the collapse of prices in 2014 and output is expected to stagnate over the forecast period, further increasing the importance of US shale producer innovation and OPEC policy.

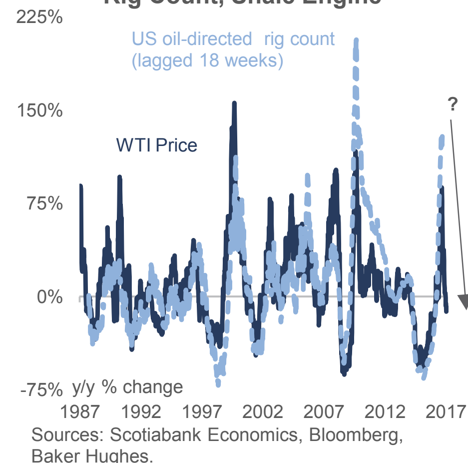
Our natural gas outlook has weakened slightly on the risk that supply gains temporarily outstrip demand in the second half of 2017, and Henry Hub prices are now expected to average $3.10/MMBtu in 2017 and $2.95 in 2018 (chart 5). Supply strength is anticipated on the back of higher gas prices, associated gas production stemming from the upturn in oil drilling, and new pipeline capacity in the US northeast that will unlock previously trapped gas from the Marcellus and Utica basins. This short-term supply concern is balanced against a longer-term outlook that sees significant growth in gas demand in the power, industrial, and petrochemical sectors as well as for export as liquefied natural gas. The market may tighten sooner than later, however, if we have a normal winter after the two warmest heating seasons (2015–16 and 2016–17) since modern records began.

Chart 3



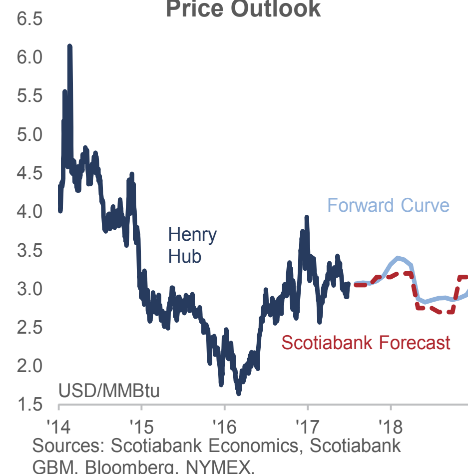
Sources: Scotiabank Economics, EIA, Baker Hughes.

Chart 4



Sources: Scotiabank Economics, Bloomberg, Baker Hughes.

Chart 5



Sources: Scotiabank Economics, Scotiabank GBM, Bloomberg, NYMEX.

METALS & MINERALS

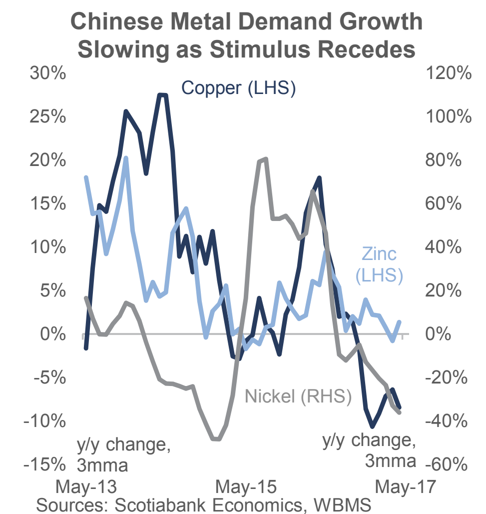
The metals story remains fundamentally unchanged, but the receding tide of Beijing's credit stimulus has slowed industrial activity in metals-intensive sectors like construction and manufacturing (chart 6), taking the wind out of prices. Economic activity in the world's largest consumer of raw commodities remains healthy, but metals in particular will experience underwhelming demand growth in 2017 relative to last year's credit boost.

Zinc's outlook remains the most promising among its base metal peers and prices staged a mid-June comeback, rallying to roughly $1.25/lb from a year-to-date low of $1.10 reached earlier that month. Zinc's journey upward took a bit of a pause after reaching a peak of $1.35/lb in February as speculators began taking profits. However, now that the headwinds of speculative position normalization have been worked through, zinc's fundamentals are reasserting themselves: treatment and refining charges continue to indicate extreme concentrate tightness, and the decline in exchange-listed zinc inventories has accelerated (chart 7). We are downgrading our 2017 outlook slightly to $1.25/lb given second quarter weakness, but prices are expected to continue rising through the forecast horizon and average $1.40/lb in 2018. **Copper markets have shifted to relative balance** (chart 8) and prices have consolidated into a stable $2.50–2.60/lb range after peaking around $2.80/lb in March. Minor supply deficits have been erased as Chinese copper demand contracts off last year's substantial stimulus push. Inventories have risen due to high prices incentivizing the selling of metal into exchange-listed sheds. Copper prices are forecast to average $2.55/lb in 2017 and rise to $2.75/lb in 2018 as the copper project pipeline empties and global demand growth strengthens after working through some of China's negative base effects.

Nickel's fortunes have dimmed since last quarter and prices are now forecast to average $4.40/lb in 2017 and $5.00/lb in 2018. The prior bullish narrative rested on political disruptions to mine supply from Indonesia, which had banned the export of raw ore in 2014 in a bid to develop domestic processing capacity, and the Philippines, where environmental audits threatened the closure of half the country's nickel capacity. Indonesia's ore export ban has since been loosened and Philippine lawmakers removed Regina Lopez—the anti-mining activist turned Environment Minister who led the charge on mine audits—from her post, lessening the risk to nickel exports. Together, these factors point to more supply when the market desperately desires deficits to eat away at the inventory overhang, likely pushing the rebalancing of the nickel market into next decade. **Aluminium prices are performing as expected** so far this year after receiving a boost from concerns that China will idle capacity in the winter to address urban smog. However, the market is still waiting to see if Beijing follows through on these plans and the price rally has spurred Chinese aluminium production, which will likely bolster exports and dampen any further price gains. Aluminium prices are forecast to average $0.85/lb in both 2017 and 2018.

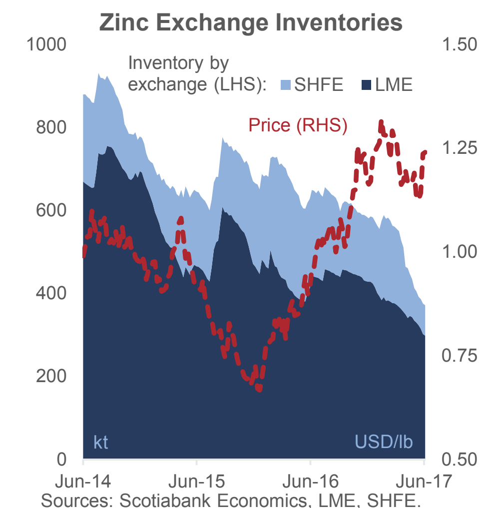
Iron ore prices have fallen precipitously to around $55/t (fines, 62% Fe, Northern China) from a mid-February peak of $95/t. This was an anticipated development after iron ore's unsustainable 4Q16–1Q17 rally—caused by a sharp uptick in Chinese imports running up against a seasonal downturn in seaborne shipments—eased following a resumption of seaborne supply and an accumulation of excess ore stocks at Chinese ports. Prices may need to temporarily fall further to push out some of the

Chart 6



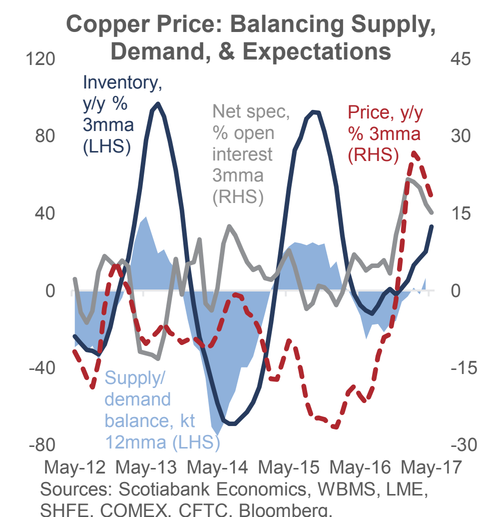
Sources: Scotiabank Economics, WBMS

Chart 7



Sources: Scotiabank Economics, LME, SHFE.

Chart 8

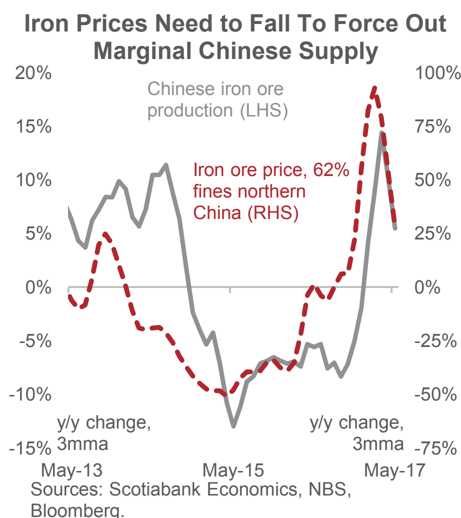


Sources: Scotiabank Economics, WBMS, LME, SHFE, COMEX, CFTC, Bloomberg.

inefficient Chinese ore supply that was brought back to the market by high prices (chart 9), and are forecast to average $65/t in 2017 and $60/t in 2018. **Hard coking coal prices have eased** after spiking to $300/t in early-April on supply disruptions stemming from Cyclone Debbie, which damaged production and transportation infrastructure in coal-rich Queensland. Barring another acute supply disruption, we expect prices to average $185/t in 2017 given first-half disruptions and ease toward $125/t in 2018.

Gold prices have firmed over the last quarter on the back of falling yields and a weaker dollar, not to mention the cornucopia of headline risks that boosted safe haven demand. We have upgraded our forecast slightly to reflect this recent strength, now at $1,225/oz in 2017 and $1,250/oz in 2018. Going forward, an increasing bias towards tightening monetary policy will reverse recent yield weakness and may tarnish gold's appeal, though we continue to see the US dollar weakening through 2018 and we are unlikely to see a material decline in political risk.

Chart 9



Sources: Scotiabank Economics, NBS, Bloomberg.

Table 1 — Commodities Forecast

	2000–2015			Annual Average		
	Low	Avg.	High	2016	2017f	2018f
WTI Oil (USD/bbl)	17	64	145	43	51	53
Brent Oil (USD/bbl)	18	67	146	45	53	56
Nymex Natural Gas (USD/mmbtu)	1.75	5.09	15.38	2.55	3.10	2.95
Copper (USD/lb)	0.60	2.36	4.60	2.21	2.55	2.75
Zinc (USD/lb)	0.33	0.81	2.10	0.95	1.25	1.40
Nickel (USD/lb)	2.00	7.45	24.58	4.36	4.40	5.00
Aluminium (USD/lb)	0.56	0.87	1.49	0.73	0.85	0.85
Iron Ore (USD/tonne)	17	68	187	58	65	60
Metallurgical Coal (USD/tonne)	39	127	330	115	185	125
Gold, London PM Fix (USD/oz)	256	845	1,895	1,251	1,225	1,250

Foreign Exchange

US DOLLAR BULL TREND SET TO MODERATE

We have adjusted our major currency forecasts to reflect the fact that we believe the secular bull trend in the **US dollar (USD)** has largely run its course. We had long expected the USD to turn lower in the second half of 2017 but it appears that the rally peaked a little sooner and a little lower overall than we were forecasting.

The expectation that the USD rally would start to reverse in the coming months was premised on the idea that the US' growth and interest rate advantage would start to weaken as we moved through the latter stages of this year and into 2018. That idea is starting to look prescient. Simply put, a lot of the good news for the USD is already largely factored. Investors are unsure that the Trump administration can advance its pro-growth agenda meaningfully at the moment, given the Russia investigation "cloud" that is lingering over Washington. This issue may be attaching a risk premium to the USD itself. Meanwhile, growth prospects are steadily improving elsewhere and other central banks are starting to look a little "twitchy" about their respective policy outlooks. The growth and monetary policy divergence narrative that supported the USD rally in the past few years now looks less compelling.

We have upgraded our forecast for the **Canadian dollar (CAD)** quite significantly; we had expected the USD to crest at CAD1.40 in through mid-year but the 1.38 high seen in early May likely represents a peak of some significance for the USD now. A major change in our broader forecasts supports a more constructive view on the CAD as we now expect the Bank of Canada (BoC) to start raising interest rates in the second half of this year (two increases in 2017) and to raise interest rates once more in 2018. A much earlier start and slightly more aggressive profile to anticipated BoC rate hikes will support the CAD in the next few months (and offset sluggish crude oil prices), we think. A narrowing in short-term US-Canada rate spreads has already supported a rebound in the CAD versus the USD and may have further room to compress. We now look for USDCAD to end 2017 at 1.28 (and we have adjusted the end 2018 forecast to 1.25).

The outlook for the euro (**EUR**) is also improving and we have adjusted our forecast up slightly. Previously, we expected EURUSD to reach 1.02 through mid-year but the January low just above 1.03 very likely marks the low ebb of the cycle. The EUR has steadily improved through the first half of the year as populist politics failed to make significant inroads in key national elections in the Eurozone, easing investor concerns about the outlook for the Eurozone project. Strong gains in European stock markets since the first round of the French presidential election have helped support the EUR. Investors appear to view the Eurozone economy as providing better returns and fewer risks than the US.

We think the European Central Bank (ECB) remains some distance from raising interest rates as inflationary pressures remain subdued. But it is clear that the end game of the ECB easing cycle is getting closer, particularly as the core Eurozone economies are reflecting relatively strong growth momentum. Nominal Eurozone rates are still negative but the downtrend in yields has stabilized and Eurozone-US spreads have stopped widening in the USD's favour. We now expect EURUSD to end this year at 1.13 and to reach 1.20 at the end of next year.

CONTACTS

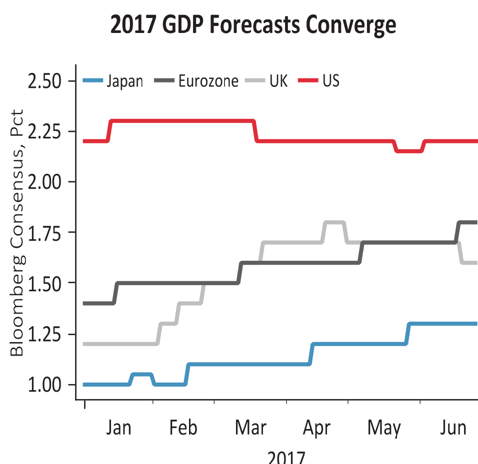
Shaun Osborne, Chief Currency Strategist
416.945.4538
Foreign Exchange Strategy
shaun.osborne@scotiabank.com

Eduardo Suárez, VP, Latin America Economics
52.55.9179.5174 (Mexico)
Scotiabank Economics
eduardo.suarez@scotiabank.com

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

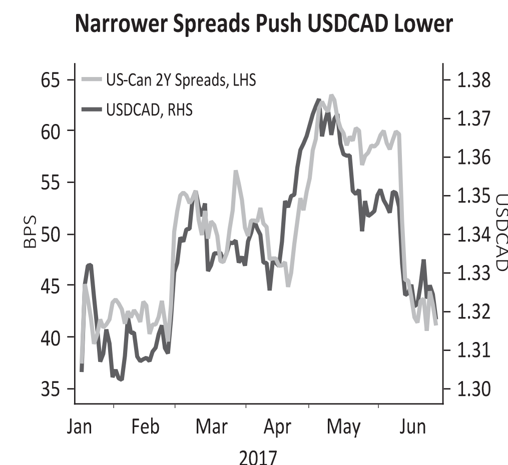
Eric Theoret
416.863.7030
Foreign Exchange Strategy
eric.theoret@scotiabank.com

Chart 1



Source: Macrobond, Scotiabank FICC Strategy

Chart 2



Source: Macrobond, Scotiabank FICC Strategy

The **pound (GBP)** has improved somewhat and we have adjusted our forecast a little higher to acknowledge the likelihood that GBPUSD based around 1.20 earlier in the year. However, risks and uncertainties remain. On the one hand, Prime Minister May miscalculated badly in calling a snap election. The result erased the Conservatives' working majority of 17 seats in parliament and left it reliant on the support of a small, Northern Irish party to pass legislation. The election has weakened the UK government's negotiating position just as it starts Brexit discussions with the European Union.

On the other hand, UK inflation has been rising, reflecting the weak exchange rate to some extent. Rising prices may compromise consumer spending at a time when real wage growth remains minimal but a prominent minority of Bank of England (BoE) policy makers has urged rates to be tightened in response to inflation. We do not expect a rate hike in 2017 but the heightened rate speculation (market pricing reflects a 45% probability of a 25bps rate hike in December, up from 36% at the end of March) has helped underpin the GBP and deflect some of the political pressure on the currency. Our forecast calls for the GBP to remain more or less range bound around current levels in the next few months but we think the GBP is susceptible to growth risks and Brexit worries and we expect it to underperform versus the EUR in the months ahead.

The **yen (JPY)** will remain vulnerable to firmer US nominal yields as we expect Bank of Japan policy settings to remain accommodative for the foreseeable future. Central bank policy makers concede that its inflation target remains out of reach. JPY weakness risks being interrupted by sporadic bouts of risk aversion, however. We expect USDJPY to end this year at 110 and end 2018 at 115.

Asian EM FX will remain susceptible to US fundamentals and tighter Fed policy. US technology stocks could swing market sentiment as well. The Federal Reserve (Fed) is likely to take a pause in raising rates at the September FOMC meeting but could begin the process of shrinking its massive USD 4.5tn balance sheet at the gathering. In mid to late third quarter, market concern about the Fed's balance sheet plan could push up long-term US Treasury yields, re-steepen Treasury yield curves and boost the USD against EM Asian currencies.

The Korean won (KRW) and the Taiwanese dollar (TWD) will respond to cross-border flows in an asymmetric manner given their stretched appreciation this year (we believe both currencies are more susceptible to equity outflows than inflows). Taiwan listed companies will pay TWD 490bn cash dividends to foreign investors from late June to early August, which could spur demand for dollars.

The market remains dubious about the Chinese yuan (CNY)'s strength as onshore USDCNY spot tends to close well above the same day's fixing. In our view, an elevated USDCNY spot/fixing gap could spur a dollar sell-off. We expect the CFETS renminbi index to trade at around the 93 mark for now. We think excessive strength of the Indian rupee (INR) is unfavourable as it could weigh on India's export competitiveness, even though the nation is not an export-driven economy. It comes as no surprise to us that rising foreign reserves reflect a slower pace of appreciation in the INR. India's benign inflation outlook is expected to lead to a RBI rate cut by October. The Thai baht (THB) will trade along with regional peers but may outperform somewhat given Thailand's large current account surplus.

LATAM FX has come under pressure recently, as markets reassess the outlook for global rates. However, there is still a differentiated performance based on individual macro stories (i.e. Brazilian real, or BRL, underperforming due to political uncertainty), and valuations (the Mexican peso—MXN—recovering from its post-US election slide). One of our main concerns for regional FX is that if we were to see a bout of global risk aversion, given the buildup of long-LATAM positions witnessed over the past 18 months (or more recently for the MXN), there could be a relatively sharp sell-off. In addition, even though the region's yields remain attractive, there could be some political volatility given the uncertainty generated by a heavy pipeline of Presidential elections (Chile, Colombia, Mexico and Brazil will all elect new Presidents by the end of 2018). Hence, the currencies of the two countries where political uncertainty seems highest (Brazil and Mexico), are the two where our forecasts are less constructive.

For the **MXN**, even though we don't foresee a sharp sell-off, we anticipate some upward pressure for the dollar cross driven by political uncertainty related to the 2018 elections. In addition, the start of the formal NAFTA negotiations in August 2017 could generate some uncertainty (although from a pure valuation perspective, MXN remains cheap). In Brazil, we expect continued uncertainty on the political front and a tougher outlook for reform approvals to weigh on the BRL. In the Andean currencies, we expect sideways trading given a stable macro outlook, accompanied by mediocre growth. The case for relatively steady Andean FX is boosted by our expectations of relatively steady commodity prices.

APPENDIX 1

International	2000–15	2016	2017f	2018f	2000–15	2016	2017f	2018f
	Real GDP (annual % change)				Consumer Prices (y/y % change, year-end)			
World (based on purchasing power parity)	3.9	3.1	3.5	3.5				
Canada	2.2	1.5	2.7	1.9	1.9	1.4	1.7	2.1
United States	1.9	1.6	2.2	2.2	2.2	1.8	2.0	2.3
Mexico	2.4	2.3	2.0	2.5	4.5	3.4	6.1	4.3
United Kingdom	1.8	1.8	1.6	1.2	2.2	0.7	3.0	2.3
Euro zone	1.2	1.6	2.2	2.0	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	6.6	6.1	2.4	2.1	2.0	2.5
India	7.0	7.6	7.1	7.6	7.2	3.4	4.2	5.2
Japan	0.9	1.0	1.2	0.8	0.0	0.3	0.8	1.1
South Korea	4.4	2.8	2.8	2.7	2.8	1.3	2.1	2.3
Indonesia	5.6	5.0	5.3	5.5	6.2	3.0	5.0	4.7
Australia	3.0	2.5	2.4	2.7	2.9	1.5	2.0	2.1
Thailand	4.2	3.2	3.2	3.2	2.7	1.1	0.6	1.5
Brazil	3.4	-3.6	0.3	2.5	6.5	6.3	4.0	4.5
Colombia	4.3	2.0	1.9	2.2	5.0	5.7	4.2	3.5
Peru	5.3	3.9	2.5	3.7	2.7	3.2	2.8	2.8
Chile	4.3	1.6	1.6	2.6	3.3	2.7	2.8	3.1

Commodities	2000–15	2016	2017f	2018f
	(annual average)			
WTI Oil (USD/bbl)	64	43	51	53
Brent Oil (USD/bbl)	67	45	53	56
Nymex Natural Gas (USD/mmbtu)	5.09	2.55	3.10	2.95
Copper (USD/lb)	2.36	2.21	2.55	2.75
Zinc (USD/lb)	0.81	0.95	1.25	1.40
Nickel (USD/lb)	7.45	4.36	4.40	5.00
Aluminium (USD/lb)	0.87	0.73	0.85	0.85
Iron Ore (USD/tonne)	68	58	65	60
Metallurgical Coal (USD/tonne)	127	115	185	125
Gold, London PM Fix (USD/oz)	845	1,251	1,225	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	1.5	2.7	1.9	1.9	1.6	2.2	2.2
Consumer spending	2.9	2.3	3.0	1.8	2.3	2.7	2.6	2.6
Residential investment	3.8	3.0	3.6	-1.4	-0.7	4.9	4.5	2.6
Business investment	2.7	-7.8	-0.3	3.2	2.4	-0.5	3.8	2.9
Government	2.2	1.8	2.0	2.0	1.0	0.8	0.2	0.6
Exports	1.3	1.0	1.8	3.7	3.8	0.4	2.9	2.5
Imports	3.1	-0.9	2.1	2.7	3.5	1.1	4.3	3.5
Nominal GDP	4.4	2.1	5.2	3.9	4.0	3.0	4.2	4.2
GDP deflator	2.2	0.6	2.4	2.0	2.0	1.3	1.9	2.0
Consumer price index (CPI)	2.0	1.4	1.7	1.9	2.2	1.3	2.2	2.2
CPI ex. food & energy	1.6	1.9	1.7	1.8	2.0	2.2	2.0	2.2
Pre-tax corporate profits	3.9	-4.5	25.0	5.0	5.9	-0.1	4.1	3.5
Employment	1.4	0.7	1.5	0.9	0.6	1.8	1.4	1.2
Unemployment rate (%)	7.1	7.0	6.6	6.5	6.3	4.9	4.4	4.3
Current account balance (CAD, USD bn)	-13.9	-67.0	-47.8	-37.4	-511	-452	-488	-534
Merchandise trade balance (CAD, USD bn)	28.2	-26.0	0.0	7.5	-668	-753	-827	-890
Federal budget balance (FY, CAD, USD bn)	-2.9	-1.0	-22.0	-24.5	-529	-585	-625	-655
percent of GDP	-0.2	0.0	-1.1	-1.1	-3.8	-3.2	-3.2	-3.2
Housing starts (000s, mn)	199	198	202	190	1.27	1.18	1.23	1.33
Motor vehicle sales (000s, mn)	1,639	1,949	2,000	1,980	15.4	17.5	17.4	17.6
Industrial production	0.5	-0.3	3.8	1.5	0.8	-1.2	1.5	2.0
	Mexico (annual % change)							
Real GDP	2.4	2.3	2.0	2.5				
Consumer price index (year-end)	4.5	3.4	6.1	4.3				
Current account balance (USD bn)	-13.9	-27.9	-20.7	-28.1				
Merchandise trade balance (USD bn)	-6.8	-13.1	-3.7	-6.5				

Quarterly Forecasts	2016				2017				2018			
Canada	Q1	Q2	Q3	Q4	Q1	Q2e	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Real GDP (q/q ann. % change)	2.8	-1.4	4.2	2.7	3.7	2.5	2.2	2.0	1.9	1.8	1.7	1.6
Real GDP (y/y % change)	1.3	1.1	1.5	2.0	2.3	3.3	2.8	2.6	2.2	2.0	1.8	1.8
Consumer prices (y/y % change)	1.5	1.6	1.2	1.4	1.9	1.5	1.7	1.7	1.7	1.9	2.1	2.1
CPI ex. food & energy (y/y % change)	1.7	2.0	2.0	1.8	2.0	1.5	1.5	1.6	1.7	1.7	1.9	1.9
Avg. of new core CPIs (y/y % change)	1.8	2.0	1.8	1.7	1.6	1.3	1.2	1.3	1.4	1.5	1.7	1.8
United States												
Real GDP (q/q ann. % change)	0.8	1.4	3.5	2.1	1.4	2.7	2.4	2.2	2.1	2.1	2.0	2.0
Real GDP (y/y % change)	1.6	1.3	1.7	2.0	2.1	2.4	2.2	2.2	2.4	2.2	2.1	2.1
Consumer prices (y/y % change)	1.1	1.1	1.1	1.8	2.6	2.0	2.1	2.0	2.0	2.4	2.3	2.3
CPI ex. food & energy (y/y % change)	2.2	2.2	2.2	2.2	2.2	1.8	1.9	1.9	2.0	2.3	2.3	2.3

APPENDIX 3

	2016		2017				2018			
Central Bank Rates	Q3	Q4	Q1	Q2	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Americas					(%, end of period)					
Bank of Canada	0.50	0.50	0.50	0.50	0.75	1.00	1.25	1.25	1.25	1.25
US Federal Reserve (upper bound)	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	7.00	7.00	7.25	7.50	7.50	7.50	7.50
Central Bank of Brazil	14.25	13.75	12.25	10.25	9.75	9.25	9.00	9.00	9.00	9.00
Bank of the Republic of Colombia	7.75	7.50	7.00	5.75	5.50	5.25	5.25	5.25	5.25	5.25
Central Reserve Bank of Peru	4.25	4.25	4.25	4.00	3.75	3.50	3.50	3.50	3.50	3.50
Central Bank of Chile	3.50	3.50	3.00	2.50	2.50	2.50	2.50	2.75	3.00	3.25
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	6.00	6.00	6.00	6.00	6.00
Bank of Korea	1.25	1.25	1.25	1.25	1.25	1.25	1.25	1.50	1.50	1.75
Bank Indonesia	5.00	4.75	4.75	4.75	4.75	4.75	4.75	5.00	5.00	5.25
Bank of Thailand	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.75	1.75	2.00
Currencies and Interest Rates										
Americas					(end of period)					
Canadian Dollar (USDCAD)	1.31	1.34	1.33	1.30	1.30	1.28	1.28	1.27	1.25	1.25
Canadian Dollar (CADUSD)	0.76	0.74	0.75	0.77	0.77	0.78	0.78	0.79	0.80	0.80
Mexican Peso (USDMXN)	19.39	20.73	18.72	18.12	18.77	19.63	19.84	19.68	19.75	20.01
Brazilian Real (USDBRL)	3.26	3.26	3.12	3.31	3.35	3.45	3.55	3.60	3.60	3.40
Colombian Peso (USDCOP)	2,882	3,002	2,874	3,046	3,015	3,005	3,100	3,100	3,050	3,000
Peruvian Nuevo Sol (USDPEN)	3.38	3.36	3.25	3.25	3.27	3.25	3.23	3.22	3.20	3.20
Chilean Peso (USDCLP)	657	670	660	664	649	655	654	652	650	648
Europe										
Euro (EURUSD)	1.12	1.05	1.07	1.14	1.12	1.13	1.15	1.18	1.20	1.20
U.K. Pound (GBPUSD)	1.30	1.23	1.26	1.30	1.28	1.28	1.28	1.28	1.31	1.31
Swiss Franc (USDCHF)	0.97	1.02	1.00	0.96	0.98	0.97	0.97	0.95	0.93	0.93
Swedish Krona (USDSEK)	8.58	9.10	8.97	8.43	8.80	8.70	8.60	8.50	8.40	8.30
Norwegian Krone (USDNOK)	7.98	8.64	8.60	8.35	8.00	8.00	7.80	7.60	7.40	7.20
Russian Ruble (USDRUB)	62.9	61.5	56.2	58.9	58.0	58.3	58.7	59.0	59.2	59.3
Asia/Oceania										
Japanese Yen (USDJPY)	101	117	111	112	110	110	112	112	115	115
Australian Dollar (AUDUSD)	0.77	0.72	0.76	0.77	0.75	0.75	0.77	0.77	0.78	0.78
Chinese Yuan (USDCNY)	6.67	6.95	6.89	6.78	6.90	6.95	6.90	6.90	6.85	6.85
Indian Rupee (USDINR)	66.6	67.9	64.9	64.6	65.5	66.5	66.0	66.0	65.5	65.5
South Korean Won (USDKRW)	1,101	1,208	1,118	1,144	1,150	1,160	1,150	1,150	1,140	1,140
Indonesian Rupiah (USDIDR)	13,042	13,473	13,326	13,328	13,450	13,500	13,450	13,450	13,400	13,400
Thai Baht (USDTHB)	34.6	35.8	34.4	34.0	34.3	34.7	34.3	34.3	34.0	34.0
Canada (Yields, %)										
3-month T-bill	0.53	0.46	0.55	0.71	0.90	1.10	1.30	1.30	1.25	1.25
2-year Canada	0.52	0.75	0.75	1.10	1.20	1.30	1.35	1.40	1.45	1.50
5-year Canada	0.62	1.11	1.12	1.39	1.50	1.65	1.75	1.85	1.90	2.00
10-year Canada	1.00	1.72	1.63	1.76	1.85	2.00	2.10	2.25	2.40	2.50
30-year Canada	1.66	2.31	2.30	2.15	2.20	2.40	2.50	2.60	2.70	2.80
United States (Yields, %)										
3-month T-bill	0.27	0.50	0.75	1.01	1.05	1.30	1.30	1.55	1.70	1.90
2-year Treasury	0.76	1.19	1.25	1.38	1.50	1.65	1.75	1.85	1.95	2.10
5-year Treasury	1.15	1.93	1.92	1.89	1.95	2.10	2.25	2.40	2.55	2.60
10-year Treasury	1.59	2.44	2.39	2.30	2.35	2.50	2.70	2.90	2.95	3.00
30-year Treasury	2.31	3.07	3.01	2.83	2.90	3.15	3.35	3.40	3.45	3.50

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Fixed Income Strategy (London)

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Foreign Exchange Strategy

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