October 5, 2017

Synchronicity

- **Global growth is strengthening as policy stimulus in some advanced economies is unwound. This is a broadly-based global expansion: all 45 industrialised OECD and related emerging-market countries are set to grow this year, the first time since the Global Financial Crisis.**
- **Price pressures remain muted, but signs of inflation are building in Canada and the US.**
- **A Federal deficit of CAD 17 bn is expected this fiscal year, improving to CAD 16 bn by the next election.**
- **Despite its recent strength, the USD is expected to weaken going forward, with currencies like the CAD appreciating significantly through the end of 2018.**
- **A gradual increase in US and Canadian policy rates is expected, but the Canadian dollar will do some of the Bank of Canada's work. More rapid rate hikes could be required if the loonie doesn't appreciate as we expect.**
- **Geopolitical risks dominate. While there are economic risks that merit surveillance, potential developments in North Korea are of far greater concern.**

For the first time since the Global Financial Crisis (GFC), all 45 industrialised OECD and related emerging-market countries are set to expand (chart 1). This is a confirmation of the narrative building throughout the year in which the sources of growth have been broadening across and within countries. There are now tangible signs that firms have joined households in contributing to the recovery in most countries. This is a most welcome development given the general weakness of business investment in companies globally since the GFC. In fact, capital spending in the more advanced OECD countries is expanding at a pace not seen in over three years (chart 2). This turnaround in investment appears to reflect a number of powerful factors: a rise in confidence as ISM indicators are at multi-year records; the still-low cost of capital; capacity constraints in some countries; and the general increase in trading partner activity, which is also captured by the acceleration in global trade growth. Given this breadth of growth geographically and its increasing diversity within countries, the foundation remains for solid global performance through at least 2018.

A similar dynamic is at play in Canada, where all the provincial economies but Newfoundland and Labrador are set to expand this year. At the national level, growth is expected to hit an unsustainable 3.1% during 2017, roughly double estimates of the Canadian economy's underlying potential this year, before slowing to 2.0% in 2018 and 1.5% in 2019 as tailwinds from Canadian consumers begin to flag and the economy reverts closer to its potential growth rate.

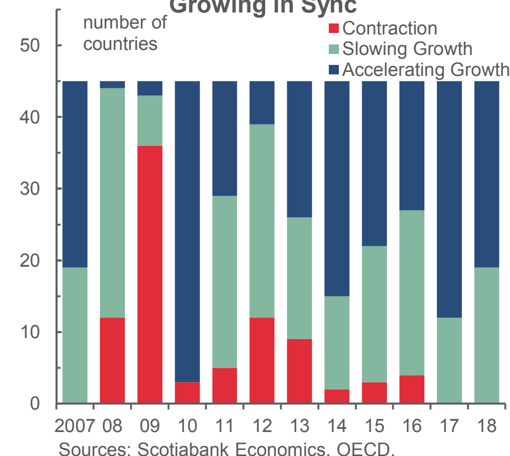
CONTACTS

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

CONTENTS

Overview	1–3
Canada	4–9
The Provinces	10–11
United States	12–16
US & Canadian Monetary Policy & Capital Markets	17–20
Mexico	21–22
United Kingdom	23–24
Eurozone	25–26
Latin America	27–34
Asia	35–39
Commodities	40–43
Foreign Exchange	44–46
Summary Forecast Tables	A1–A3

Chart 1



Sources: Scotiabank Economics, OECD.

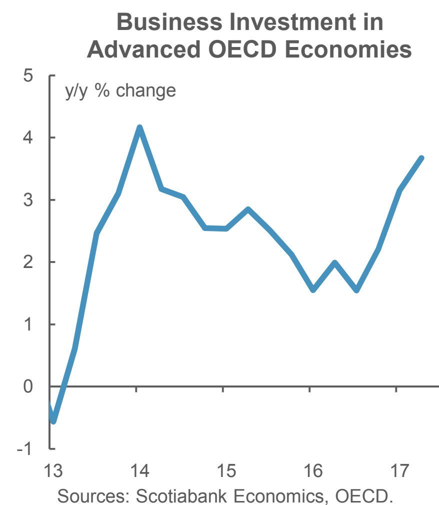
Alberta and BC will lead the pack in 2017, with Alberta expanding by nearly 4% and BC by 3.5%. BC's growth follows multiple years of higher than national average growth, whereas Alberta's outperformance reflects to some degree a natural rebound from a very severe recession and rebuilding following the Fort McMurray wildfires. So while Alberta's growth outpaces by far that of other provinces, there remains much excess capacity and the economy doesn't feel like it is at the forefront of Canadian growth.

The sectoral breadth of the recovery in Canada also impresses. More sectors are expanding now than at any point since the GFC, another indication that the expansion is broadly based and well supported (chart 3).

Stronger Canadian growth provides an opportunity for better fiscal outcomes. We anticipate that the Federal government will seek to go into the next election with an improving budget balance, building on the much stronger-than-expected results recorded this fiscal year. Our operating assumption is that the federal deficit will be CAD 17 bn in fiscal year 2017–18 and improve to CAD 16 bn by 2019–20, as the adjustment for risk remains unused.

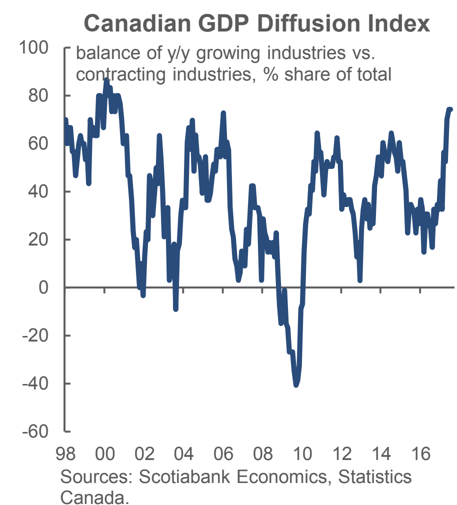
Hurricanes Harvey and Irma dominated US news in recent weeks, but despite the havoc they wrought in the southern states of the US and Puerto Rico, neither is expected to have a meaningful impact on overall US economic activity. US growth averaged just above 2% in the first half of 2017, and looks set to come in at a similar pace in the second half following the storms. This steady growth performance, with 2.2% y/y projected in 2017 and 2.3% y/y in 2018, nevertheless remains above both the Fed and Scotiabank Economics' estimates of potential growth at around 1.8% until 2019. Strong consumption growth combined with a rebound in industrial activity should tip the US into excess-demand territory during the next couple years even if Washington proves unable to deliver on meaningful changes in taxes and spending.

Chart 2



Sources: Scotiabank Economics, OECD.

Chart 3



Sources: Scotiabank Economics, Statistics Canada.

Growth and inflation remain largely coupled in the US and Canada. Price pressures are building in both countries, even though inflation remains well below targeted levels. In the US, a number of transitory factors are holding prices down. As these play out, and wage growth accelerates, inflation should gradually rise to 2%. We continue to believe that the Fed will carry on with its gradual pace of tightening, with a 25 bps hike in December, followed by two more hikes next year. In Canada, our empirical analysis implies that the link between inflation and output appears tighter than in the US. As in the US, labour market developments remain critical to inflation dynamics and the recent pick-up in Canadian wages suggests price increases will accelerate in the months ahead. This underlies our view that the Bank of Canada will raise rates gradually, with the next hike in December and two more during 2018. In both countries, longer-term interest rates will rise as the Fed's balance-sheet unwind proceeds and short-term rates are ratcheted up, but the continuation of quantitative easing programs in Europe and Japan will limit the extent to which US, and therefore Canadian, longer-term rates will increase.

At this point, we think there are upside risks to the Canadian interest rate forecast relative to the US rate view. The tighter link between output and prices north of the border could lead to greater inflation surprises in Canada compared with the US, suggesting the Canadian dollar could appreciate over the next year. Our models suggest a fair value of about 83 cents for the CAD based on our forecast of variables that influence the dollar, but we expect markets to overshoot this level as loonie-supportive sentiment returns. If the Canadian dollar remains at current levels, the Bank of Canada would need to tighten policy further, with

potentially 25–50 bps in additional tightening by early 2019 relative to our current forecast.

Political developments remain salient in the Pacific Alliance countries. Elections in Chile, Colombia, and Mexico, as well as political turmoil in Peru, imply some risks to the outlook, but we expect growth to strengthen significantly in 2018 as uncertainty diminishes, private and public investment picks up, and the region continues to benefit from strength in the world's major economies, which leads to greater demand for commodities and other major emerging-market exports.

The synchronized nature of the ongoing recovery bodes well for its sustainability. Concerns remain about the potential impact of the Fed's efforts to unwind its balance sheet, the prospect of additional central banks tightening monetary policy, and national worries such as the level of household indebtedness in Canada. These risks are reasonably well balanced by, amongst other things, the possibility that asset prices could remain elevated, confidence could improve further, and investment could accelerate more rapidly than currently projected. Importantly, we do not build into our forecasts any impact from potential tax reform in the US. In our view, the most pronounced risks to the global economy relate to possible developments with North Korea, where a misstep by either side has the capacity to lead to catastrophic results for the region, significant risks of contagion across financial markets, and severe shocks to global household and business confidence.

Table 1

Global Real GDP	2000–16	2016	2017f	2018f	2019f
			(annual % change)		
World (PPP)	3.9	3.2	3.6	3.6	3.5
Canada	2.1	1.5	3.1	2.0	1.5
United States	1.9	1.5	2.2	2.3	1.7
Mexico	2.4	2.3	2.4	2.7	3.1
United Kingdom	1.8	1.8	1.5	1.2	2.0
Euro zone	1.2	1.6	2.3	2.0	1.8
Germany	1.3	1.7	2.3	2.6	2.2
France	1.3	1.2	1.8	2.0	1.8
China	9.4	6.7	6.7	6.4	6.1
India	7.0	7.6	6.5	7.4	7.6
Japan	0.9	1.0	1.6	1.0	0.8
South Korea	4.2	2.8	2.8	2.7	3.0
Australia	2.9	2.5	2.4	2.7	2.5
Thailand	4.0	3.2	3.3	3.2	3.4
Brazil	2.6	-3.6	0.3	2.5	2.7
Colombia	4.0	2.0	1.9	2.5	3.1
Peru	5.1	4.0	2.5	3.7	4.2
Chile	4.1	1.6	1.4	2.8	3.2

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

Canada

- **Growth is expected to hit 3.1% during 2017, more than double most estimates of the Canadian economy's underlying potential this year, before slowing to 2.0% in 2018 and 1.5% in 2019 as tailwinds from busy Canadian consumers begin to wane.**
- **Investment, industrial activity, and exports are beginning to bear more of the burden of growth, setting the stage for a more sustainable and balanced outlook.**
- **Despite consistent year-on-year increases in debt, Canadian households have seen even stronger increases in asset values, which position them to weather progressively rising interest rates given their relatively high equity in their homes.**

BROADENING GROWTH, RISING POTENTIAL

The Canadian economy roared ahead in the first half of 2017, expanding well above potential at quarter-on-quarter annualized rates of 3.7% in Q1 before accelerating further to 4.5% in Q2. We expect momentum to continue through the second half (table 1) to sustain a forecast of 3.1% real GDP growth for the whole of 2017—up substantially from the 2.0% both we and consensus forecasts anticipated at the beginning of the year. Although the sources of Canadian growth are broadening, they still remain heavily concentrated in consumption, which is unlikely to be fully sustainable as interest rates rise.

We expect Canadian growth to decelerate toward 2.0% in 2018 and 1.5% in 2019 as the effects of tighter monetary policy from the Bank of Canada take hold and growth returns to the economy's underlying potential (table 2). In its April 2017 *Monetary Policy Report*, the Bank proposed that potential GDP growth—the rate consistent with the Bank's 2% inflation target—would range between 1.0 and 1.6% in 2017, 1.1 and 1.7% in 2018, and 1.1 to 1.9% in 2019, for an average of 1.4% during 2017–19. Going forward, Scotiabank Economics projects that potential growth will average 1.7% in 2017–19, at the upper bound of the Bank's projections. We expect the Bank of Canada also to revise upward its expectations for potential growth to reflect improving labour productivity, increasing investment, and capital deepening—which would imply less excess demand (chart 1) and the need for only gradual further rate increases along the lines we have projected (table 1 again).

These projections of Canada's potential underlying growth rates are all still well below the Bank's 2.0% estimate for the period 2010–14. After a single year of relatively quick growth in 2017, our expectation that growth will slow down again toward a middling underlying trend should prompt renewed focus on efforts to raise Canadian productivity once uncertainties about our trading relationship with the United States become resolved.

CONTACTS

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

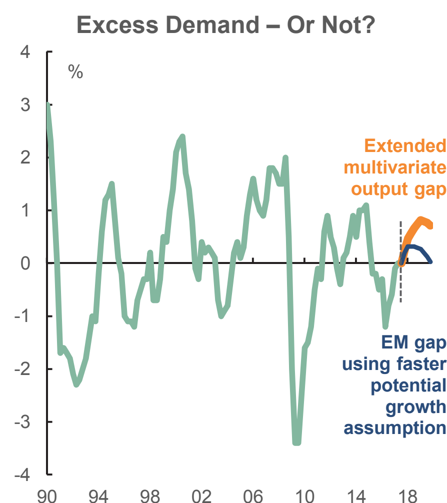
Carlos Gomes
416.866.4735
Scotiabank Economics
carlos.gomes@scotiabank.com

Juan Manuel Herrera
416.866.6781
Scotiabank Economics
juanmanuel.herrera@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



Source: Scotiabank Economics.

FADING CONSUMER TAILWINDS

Consumers remain the biggest drivers of Canadian economic activity, though they are beginning to pass the baton of growth to other sectors of the real economy. Household consumption is expected to add two percentage points to Canada's overall GDP advance in 2017, its largest contribution in seven years. Consumer confidence is at its highest level in a decade and major purchase plans remain elevated.

Incomes and purchasing power have been bolstered by increased government net transfers and strong labour market conditions. Rapid job growth—the quickest in four years—has pushed the national unemployment rate to a cycle-low 6.2%, equivalent to 5.4% under the methodology used in the United States. The prime-age employment-to-population ratio is close to an all-time high of 82.3%, which implies that labour-market slack has been almost entirely absorbed.

Wealth gains associated with rising home prices have provided further fuel. Residential real estate assets have generated CAD 236 bn in increased household net worth over the past year. Assuming a wealth effect of 5 cents on the dollar, this is likely to have added upwards of a percentage point to the annual advance in consumer spending.

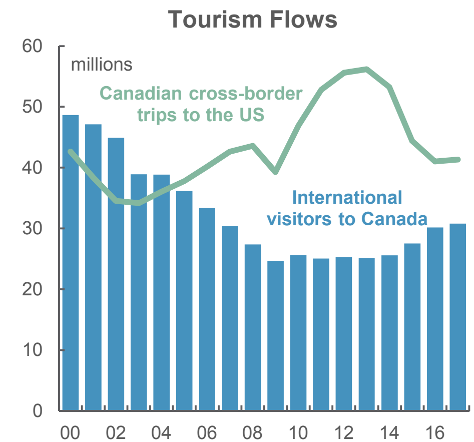
Several major celebrations in Canada this year, including the 150th anniversary of Confederation, have contributed to a notable rise in tourism-related expenditures, including on air and rail transportation, accommodations, food and beverage services, and arts and entertainment. The number of international tourists to Canada this year is tracking its highest level since 2006 (chart 2) as rising connection traffic through Canada's international air hubs and tighter travel restrictions into the US provide additional support to our visitor numbers. Meanwhile, a Canadian dollar that has averaged below 80 US cents so far in 2017 has limited cross-border shopping trips by Canadians to the United States (chart 2 again).

Consumers are unlikely to be able to maintain their recent spending momentum. While hiring surveys remain positive, the pace of job growth is expected to slow with the labour market nearing full employment in many parts of the country and business confidence ebbing in some sectors. More firms are reporting labour shortages that could limit payroll expansion. Recent and pending increases to minimum wages in a number of provinces also could hold back hiring.

Several other factors are expected to reinforce a more cautious trend in consumer spending. The boost to incomes from the rollout of the Canada Child Benefit in mid-2016 has peaked, and is expected to fade over the coming year. Household disposable income growth is forecast to slow from 4.5% in 2017 to an average of 3.5% during 2018–19.

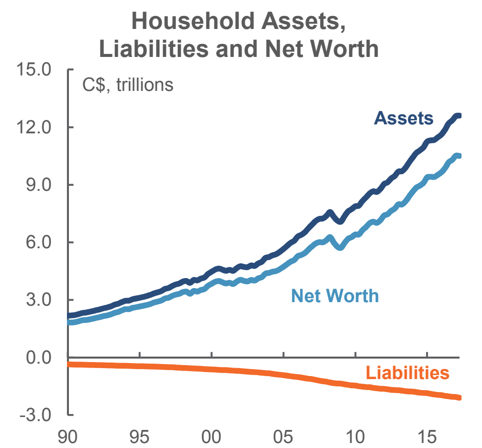
The likelihood of a further modest cooling in national home sales would dampen purchases of durable goods and renovation demand. Motor vehicle sales are set to move lower during 2018–19 after five consecutive record-breaking years that have driven per household purchases to record highs.

Chart 2



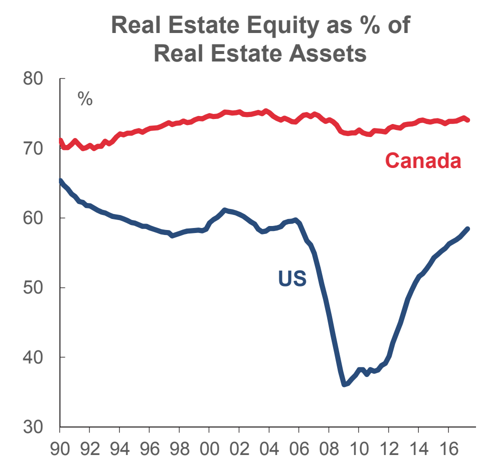
Sources: Scotiabank Economics, Statistics Canada.

Chart 3



Sources: Scotiabank Economics, Statistics Canada.

Chart 4



Sources: Scotiabank Economics, Federal Reserve Board, Statistics Canada.

Rising interest rates also could squeeze household budgets and divert some discretionary spending. A 100 bps increase in the effective interest rate, all else equal, would lift the aggregate household debt-service to personal disposable income (PDI) ratio from its current level of 14.2% to just under 16%.With growth in mortgage liabilities averaging over 6% y/y since 2015, total principal repayments overtook interest payments late last year on housing debt, though non-mortgage debt-servicing remains the greatest drag on monthly incomes.

Canadian household balance sheets do, however, look well-positioned to weather the recent and expected policy rate increases by the Bank of Canada. Although household liabilities have expanded rapidly in recent years, household assets have expanded three times faster over the last two and a half decades (chart 3). Although real estate accounts for around 40% of Canadian households' assets compared with about 20% in the US, Canadians' equity share in their homes remains consistently higher than in the US (chart 4) and negative-equity positions are nearly non-existent.

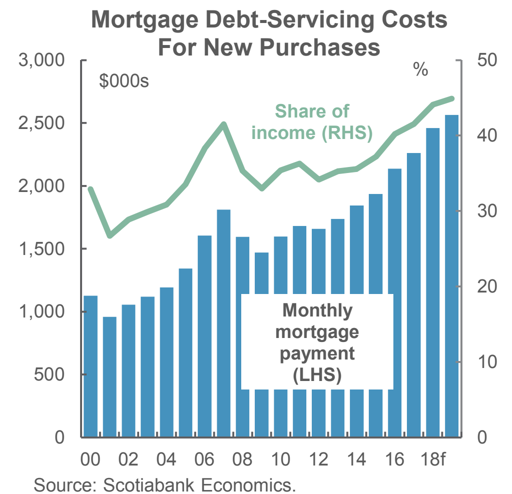
CANADA'S HOUSING CYCLE HAS LIKELY PEAKED

Deteriorating housing affordability, moderately higher borrowing costs, and consecutive rounds of regulatory policy changes have moderated national resale activity. Much of the recent slowdown in sales and softening in prices has been concentrated in the Greater Toronto Area and surrounding municipalities, and follows the implementation of a series of provincial measures in the spring of 2017. Activity in the region is showing tentative signs of stabilizing, which implies that market sentiment has now largely adjusted to these latest rule changes.

Low unemployment and strong household formation reinforced by ageing Millennials and high immigration remain supportive of housing demand, further buttressed by international capital inflows. Nonetheless, we anticipate some moderation in home sales over the forecast horizon, as rising borrowing costs and tougher mortgage-qualification criteria lead to some further erosion in affordability, especially for first-time buyers in major urban markets. Under our base-case forecast for interest rates, and assuming relatively stable home prices, average mortgage carrying costs for new buyers are projected to rise by about 8% in 2018 and by a further 4% in 2019, easily outpacing average annual per capita household income growth of around 2.5% (chart 5). Further rule changes, including more stringent stress tests for uninsured mortgages, are expected to be unveiled later this year and would exert additional drag on new buyers.

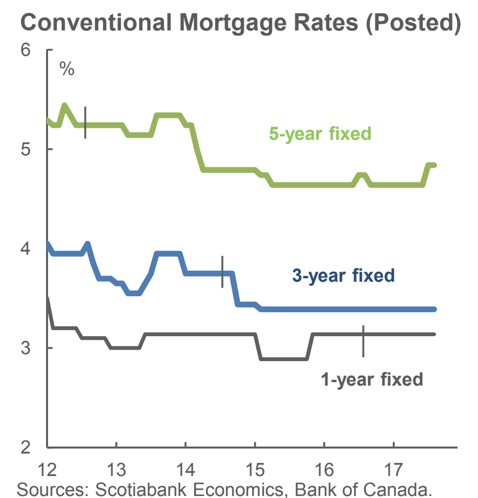
Existing mortgage holders, which account for only about a third of Canadian households, have some insulation from rising rates. The majority of mortgages in Canada are fixed-rate, with the 5-year term by far the most popular. As a result, rising borrowing costs feed through only gradually to mortgage holders. In fact, a majority of fixed-rate mortgages coming due in the near term will roll over at interest rates comparable to, or lower, than those that have been paid since origination (chart 6). Many households with sufficient home equity may also be able to extend their amortization periods to lower monthly debt-servicing costs further.

Chart 5



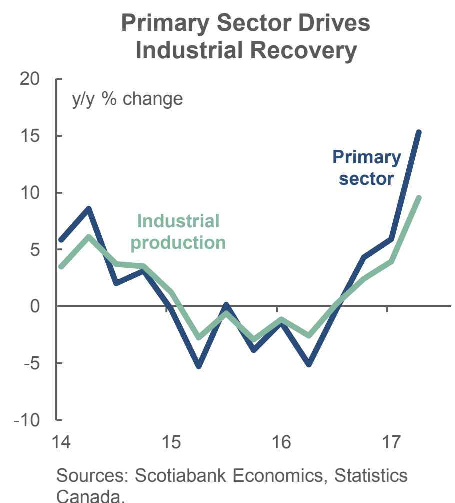
Source: Scotiabank Economics.

Chart 6



Sources: Scotiabank Economics, Bank of Canada.

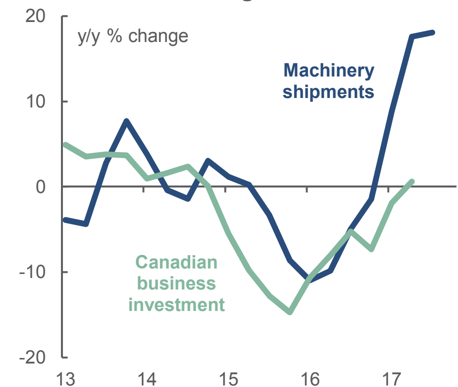
Chart 7



Sources: Scotiabank Economics, Statistics Canada.

New home construction and renovation activity remain elevated, but are expected to trend lower as resale-market conditions cool. Housing starts are forecast to total a five-year high of 212,000 units in 2017, before slowing to 198,000 and 188,000 units, respectively, in 2018 and 2019 (table 2 again)—even with increased demand from Millennials ageing into their prime household formation years and still-high international immigration rates. Our above-consensus forecast for 2018 takes into account the current elevated level of permits trending around 230,000, record pre-construction condo sales in Toronto, affordable housing initiatives in some provinces, and rebuilding in Alberta. The resulting reduction in residential investment will be felt broadly, with negative spillovers to a range of goods and service industries, including manufacturing, retail and wholesale trade, transportation, and professional services.

Chart 8



Sources: Scotiabank Economics, Statistics Canada.

PRIMARY SECTOR REVIVAL

Industrial activity is advancing at its fastest pace in six years, led by 10.1% growth of volumes in the primary sector (chart 7). The volume of oil and gas extraction year-to-date has expanded by 22% y/y, while mining output is reviving alongside strengthening global demand. For example, Canadian metal export volumes have accelerated to a 12% y/y gain in the last three months, reversing nearly two years of declining shipments. This trend is also evident across other metal-producing countries and reflects an upturn in business investment as global growth synchronizes. Capital expenditure growth among the advanced OECD economies picked up to 3.7% y/y in Q2, double the pace of the total annual expansion in 2016. Most of Canada's mining exports are sent outside of North America, with less than 20% directed to the US. This provides a more direct perspective on strengthening global economic activity compared with data on overall Canadian merchandise exports since more than 70% of these merchandise exports are shipped to the United States.

DECADE-HIGH OPERATING RATES LIFT MACHINERY DEMAND

A broadly-based upturn is also underway for Canadian manufacturers, with industrial operating rates on the rise and a growing order backlog helping to lift business confidence to one of its highest levels of recent decades. Machinery and shipbuilding are leading the output gains, with domestic demand for manufactured products outpacing export growth for the first time in several years. An improving economic backdrop and rising profitability are leading a growing number of companies to increase their capital spending plans, resulting in a 17% y/y increase in Canadian machinery shipments to date in 2017 (chart 8).

Table 1

Quarterly Canadian Forecasts	2017			2018				2019			
	Q2	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Economic											
Real GDP (q/q ann. % change)	4.5	2.3	2.2	1.7	1.7	1.6	1.6	1.4	1.4	1.3	1.3
Real GDP (y/y % change)	3.7	3.3	3.2	2.7	2.0	1.8	1.6	1.6	1.5	1.4	1.4
Consumer prices (y/y % change)	1.3	1.4	1.5	1.6	1.8	2.0	2.0	2.0	2.0	2.1	2.1
CPI ex. food & energy (y/y % change)	1.4	1.5	1.5	1.6	1.8	1.9	1.9	1.9	1.9	1.9	1.9
Avg. of new core CPIs (y/y % change)	1.4	1.5	1.5	1.6	1.8	1.9	1.9	1.9	1.9	1.9	1.9
Financial											
Canadian Dollar (USDCAD)	1.30	1.20	1.20	1.18	1.18	1.15	1.15	1.17	1.17	1.20	1.20
Canadian Dollar (CADUSD)	0.77	0.83	0.83	0.85	0.85	0.87	0.87	0.85	0.85	0.83	0.83
Bank of Canada Overnight Rate (%)	0.50	1.00	1.25	1.50	1.50	1.75	1.75	2.00	2.00	2.00	2.00
3-month T-bill (%)	0.71	1.00	1.30	1.55	1.60	1.80	1.85	2.05	2.05	2.05	2.05
2-year Canada (%)	1.10	1.52	1.75	1.85	1.90	1.95	2.00	2.05	2.05	2.10	2.10
5-year Canada (%)	1.39	1.75	2.00	2.05	2.10	2.15	2.20	2.25	2.25	2.30	2.35
10-year Canada (%)	1.76	2.10	2.20	2.25	2.35	2.45	2.60	2.70	2.75	2.80	2.80
30-year Canada (%)	2.15	2.48	2.50	2.55	2.60	2.75	2.90	2.95	3.00	3.05	3.10

Sources: Scotiabank Economics, Statistics Canada, Bloomberg.

The rebound in machinery demand is strongest in Alberta, with shipments to the primary sector year-to-date surging around 46% y/y through July. However, the comeback is spread across most provinces, and reflects the highest nationwide industrial operating rate of the past decade. Demand for industrial machinery has increased 25% y/y in Ontario this year to date, and is also reviving quickly in British Columbia. Order growth is even stronger, which is lifting the sector's backlog to record highs. The machinery sector now accounts for 10% of Canada's overall manufacturing backlog, roughly double its share of current shipments.

AN EXPORT BOUNCE

In the second quarter of the year, Canadian exports posted their best performance since late-2011 as nearly every major export sector recorded gains. The slight rebound in oil prices, with WTI oil currently trading at around USD 50, has boosted the value of Canada's resource-sector exports (chart 9). While trading at nearly two times its early-2016 trough of USD 26, WTI oil is still selling well below its mid-2014 high of USD 107. At the same time, rising domestic investment has allowed capacity-constrained manufacturing sectors to take advantage of stronger growth across industrialized and emerging economies and increase their foreign sales. The third quarter is likely to see a brief pause in this trend owing to the temporary closure of some Canadian auto plants for retooling, but exports should resume their recent expansion as these factories come back online.

Despite the recent boost in exports, Canada's monthly trade deficit remains fairly high at just over CAD 3 bn in July, though is expected to contract towards the end of year, pushing the country's current account deficit below 3% of GDP for the first time since 2014, and continue to shrink in the coming years (table 2). Yet, with the loonie projected to appreciate further, firms may take advantage of the stronger currency to import capital goods and consumers' extended shopping spree might get a last boost, which may together prevent a faster narrowing of the merchandise trade balance.

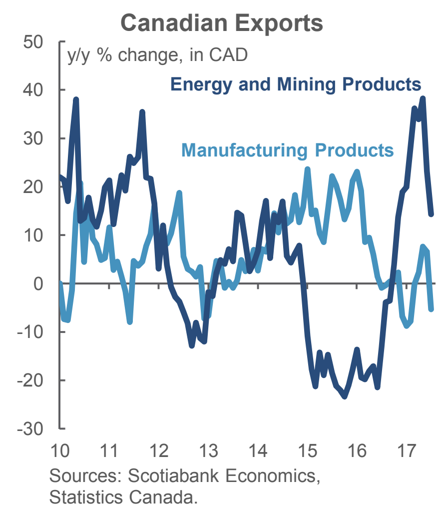
HEAVIER RELIANCE ON FOREIGN FINANCING

External trade deficits have to be financed, and portfolio flows into Canadian securities picked up from late-2015 and pushed net foreign purchases of Canadian assets to a year-to-date record of CAD 124 bn at end-July (chart 10). The financial sector's increasing reliance on wholesale finance from abroad has driven about half of new Canadian corporate bond issuance this year (chart 11).

THE CHALLENGE OF SUSTAINING A DIMINISHED FEDERAL DEFICIT

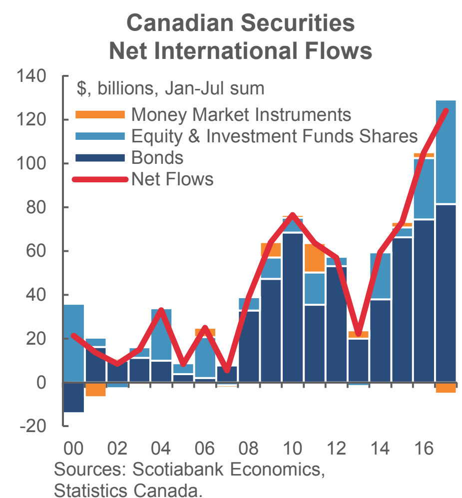
Ottawa's final 2016–17 deficit widened to CAD 17.8 bn from the modest one billion dollar shortfall in 2015–16, but this still represents a substantive improvement of more than CAD 5 bn compared with the original *Budget* estimate (excluding the CAD 6 bn risk adjustment) and the government's forecast last March. Revenues were CAD 1.4 bn higher than the government projected in March, but the CAD 3.8 bn shortfall in spending, due in large part to delays, was even bigger. Looking ahead, a desire to stabilize or even trim future budget shortfalls will make it difficult for the federal government to carry forward the spending delayed from fiscal 2016–17. For the current fiscal year, 2017–18, stronger nominal GDP growth in calendar 2017 should help hold the deficit around CAD 17.0 bn (excluding the adjustment for risk), albeit with some offset from higher-than-projected interest rates.

Chart 9



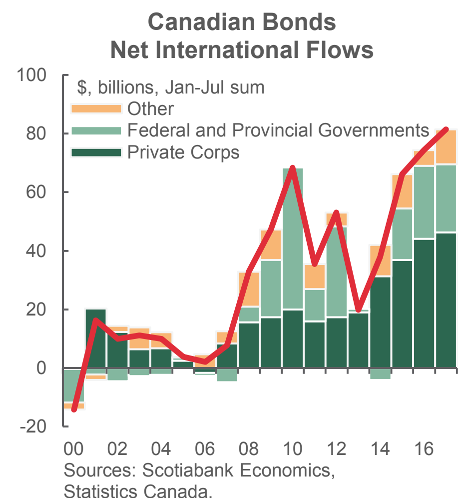
Sources: Scotiabank Economics, Statistics Canada.

Chart 10



Sources: Scotiabank Economics, Statistics Canada.

Chart 11



Sources: Scotiabank Economics, Statistics Canada.

For 2018–19 and 2019–20, however, as the federal government returns to the polls, the stakes will be higher to make further progress on narrowing the budget shortfall. The anticipated moderation in Canadian growth during calendar 2018 and 2019, in line with the *Budget* assumptions tabled last March, will make this more challenging. Trimming the annual deficit toward CAD 15 bn by the end of the decade will likely require some significant expenditure re-profiling, with big-ticket infrastructure projects one option for doing so.

In most Provinces, 2017's upbeat growth is likely to yield significant additional revenue during fiscal 2017–18, but the surge is likely to be short-lived as provincial output growth slows in 2018 and 2019. General sales tax and land transfer revenues, for example, will be quite sensitive to the forecast decline in housing starts and moderating home sale transactions. Thus, the better-than-expected 2017–18 results do not substantively alter the Provinces' challenge of sustaining balanced books in later years.

Table 2

Canada	2000–16	2016	2017f	2018f	2019f
	(annual % change, unless noted)				
Real GDP	2.1	1.5	3.1	2.0	1.5
Consumer spending	2.9	2.3	3.5	2.0	1.6
Residential investment	3.7	3.0	2.7	-1.3	-1.2
Business investment	2.1	-7.8	1.7	3.7	2.7
Government	2.2	1.8	1.9	1.8	0.9
Exports	1.3	1.0	3.0	3.8	3.1
Imports	2.8	-0.9	3.9	3.1	2.7
Nominal GDP	4.2	2.1	5.6	4.2	3.9
GDP Deflator	2.1	0.6	2.4	2.2	2.4
Consumer price index (CPI)	1.9	1.4	1.5	1.9	2.1
CPI ex. food & energy	1.6	1.9	1.6	1.8	1.9
Pre-tax corporate profits	3.3	-4.5	22.0	5.0	1.0
Employment	1.3	0.7	1.7	1.0	0.8
Unemployment rate (%)	7.1	7.0	6.5	6.3	6.3
Current account balance (CAD bn)	-17.0	-67.0	-60.9	-58.2	-52.2
Merchandise trade balance (CAD bn)	25.1	-26.0	-17.1	-17.1	-14.2
Federal budget balance* (FY, CAD bn)	-2.8	-1.0	-17.8	-17.0	-16.0
percent of GDP	-0.2	0.0	-0.9	-0.8	-0.7
Housing starts (000s)	199	198	212	198	188
Motor vehicle sales (000s)	1,657	1,949	2,000	1,980	1,950
Industrial production	0.5	-0.3	5.9	2.1	1.0
WTI oil (USD/bbl)	63	43	50	52	56
Nymex natural gas (USD/mmbtu)	4.94	2.55	3.08	2.85	3.00

Sources: Scotiabank Economics, Statistics Canada, CMHC, Bloomberg. * Canadian federal forecast for FY18 & FY19 excludes risk adjustment.

RISKS TO A RENEWED FOCUS ON PRODUCTIVITY

The recent conclusion in Ottawa of the third round of tripartite talks on the North American Free Trade Agreement (NAFTA) left Canadian negotiators still waiting to receive draft text from the US side on their proposed changes to major elements of the accord such as rules of origin and dispute-settlement mechanisms. These delays continue to augur for one of two possible outcomes: a conclusion to the talks by the end-2017 target date that results in only limited changes to the agreement; or, an extension of the talks beyond 2018's election season with prospects for major changes in 2019 just as constrained. Even if our expectation that NAFTA remains intact is realised, an elongated period of negotiations, combined with other potential American trade actions on softwood, steel, aluminum, solar panels, and jet aircraft, among other potential targets, would increase uncertainty and put a damper on both domestic and foreign direct investment into Canada.

This potential pall on investment comes right as Canada pivots from a period of emergency monetary accommodation and recession-fighting fiscal stimulus to a post-crisis economic footing, where well-placed capital expenditure will be needed to raise estimates of our relatively low potential growth rate from 1.7%, back to pre-2008 rates closer to 2.0%. Once the uncertainty posed by the NAFTA talks has passed, Canada's longer-term prosperity will hinge critically on turning our national conversation toward finding the right mix of private and public investment to put our economy on a sustained path toward faster long-term growth.

The Provinces

- **In 2017, Alberta, after a steep two-year decline, and British Columbia are forecast to lead elevated provincial growth. In 2018–19, as consumption and housing cool, projected provincial growth is more balanced, with a greater reliance on exports and business investment in most regions.**
- **External opportunities, including CETA and US trade/tax developments, add to the provincial governments' heavy domestic policy agenda.**

This year's consumer spending surge continues across Canada with retail sales through July rising more than 5% y/y in the Maritimes, Central Canada and the two westernmost provinces. Driving stronger spending in most provinces is the rise in full-time employment, led by BC's and Prince Edward Island's 4% y/y gains through August (chart 1). Hiring is turning up in Alberta, unleashing some pent-up spending demand; modest job creation is around the corner in Saskatchewan, but employment remains weak in Newfoundland and Labrador as major resource projects are completed. The slow emergence of real purchasing power for households is uneven this year across the provinces, but it is expected to become more widespread, albeit modest, over the next year. Personal tax relief is anchoring Quebec's 2.2% first half increase in real household consumption versus the latter half of 2016 and BC's hefty 9.3% retail sales gain through July. Tourism also is boosting local spending, with international travelers up more than 2% through July in Nova Scotia, Central Canada, Alberta and British Columbia.

In contrast to Greater Vancouver and Ontario's Greater Golden Horseshoe, a number of cities such as Halifax, Winnipeg and Ottawa are witnessing moderate average home price gains of 3%–6% to date this year. Housing starts continue to surprise on the upside, driven by seven provinces ahead of their 2016 levels, and housing completions will add to durable goods sales into 2018. But just as historically low interest rates have emboldened consumer expenditures in recent years, the withdrawal of monetary stimulus, combined with other regulatory tightening, is expected to instill increasing consumer caution through 2019.

Although energy products dominate this year's national gain in exports, pockets of strength include mining and machinery shipments from Quebec and Western Canada. For Ontario, these gains partially offset some weakness in motor vehicles and parts plus metals. Early indicators point to rebounding machinery & equipment investment in many regions. Quebec reports a 7.5% real machinery & equipment investment gain in the first half of 2017 relative to the second half of 2016.

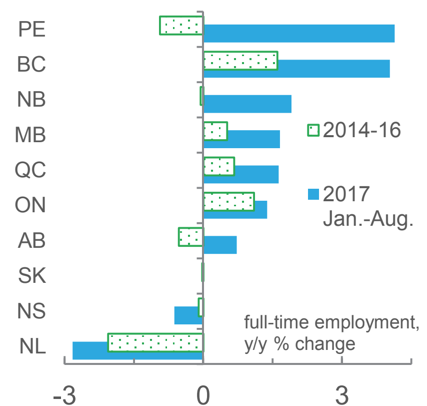
Supporting job creation and incomes is a range of business services, from financial institutions to information technology. Professional, scientific and technical services employment is up more than 4% through August in five provinces. Acknowledging that technology is driving change across most industries, we have traced technology-oriented occupations in natural and applied sciences (e.g., engineers, information systems and computer software specialists). In these occupations, Ontario and BC have recently demonstrated significant employment strength, while a rebound is occurring in Alberta as oil & gas-related activity recovers (chart 2). Weekly wages for these occupations were 147% higher than the national average across all occupations in 2016, testifying to their economic contribution.

CONTACTS

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

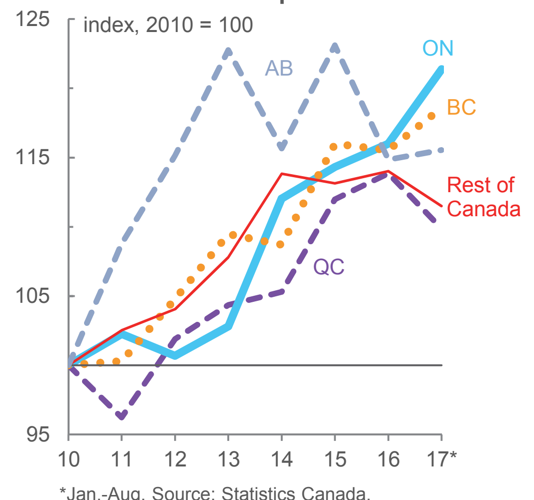
Marc Desormeaux
416.866.4733
Scotiabank Economics
marc.desormeaux@scotiabank.com

Chart 1



Source: Statistics Canada.

Chart 2



*Jan.-Aug. Source: Statistics Canada.

For provincial governments, the forecast period promises multiple layers of change. Federal policy objectives are propelling adjustments—from an increased focus on mental health issues and home care via the *Health Accords* to a renewed emphasis on attracting skilled immigrants to carbon pricing in all Provinces and Territories as of January 2018. Provinces and municipalities are struggling to make life more "affordable" for their residents, hampered in some jurisdictions by escalating power prices and in the future by the cost of operating and maintaining the extensive new infrastructure now under construction. Provincial economic development programs focused on building exports face the opportunities offered by the *Comprehensive Economic and Trade Agreement* with Europe and the uncertainties inherent in the current NAFTA renegotiations.

In the anticipated environment of rising interest rates, the Provinces' success post-recession in lengthening the term of their debt is expected to offer some insurance. But the resolution of other concerns, such as rising health care costs from an expanding Seniors cohort, is ongoing as new issues emerge, such as the opioid crisis. Careful provincial expenditure management will continue to be required to achieve sustainable black ink, even though five Provinces forecast surpluses for the current fiscal year and several other Provinces are making substantive progress in narrowing their *Budget* gaps.

Table 1

The Provinces				(annual % change except where noted)							
Real GDP	**CA**	**NL**	**PE**	**NS**	**NB**	**QC**	**ON**	**MB**	**SK**	**AB**	**BC**
2000–16	2.1	2.5	1.8	1.3	1.2	1.7	2.0	2.4	1.9	2.6	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	3.1	-1.6	1.6	1.5	1.2	2.8	3.1	2.6	2.0	3.8	3.5
2018f	2.0	-0.4	1.4	1.2	0.9	1.9	2.2	2.0	1.8	2.1	2.3
2019f	1.5	0.7	1.1	0.8	0.5	1.5	1.7	1.5	1.6	1.7	1.7
Nominal GDP											
2000–16	4.2	5.4	4.3	3.3	3.2	3.6	3.9	4.4	5.4	5.7	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	5.6	2.8	3.6	3.5	3.2	4.8	5.4	4.7	5.2	7.5	5.9
2018f	4.2	2.8	3.3	2.9	2.7	3.8	4.4	3.9	4.1	4.5	4.5
2019f	3.9	3.7	2.9	2.6	2.3	3.5	3.9	3.5	4.1	4.6	3.9
Employment											
2000–16	1.3	0.8	1.0	0.6	0.4	1.3	1.3	0.9	1.1	2.3	1.4
2016	0.7	-1.5	-2.3	-0.4	-0.1	0.9	1.1	-0.4	-0.9	-1.6	3.2
2017f	1.7	-3.7	3.0	0.6	0.4	2.1	1.4	1.3	0.2	1.1	3.6
2018f	1.0	-1.0	0.2	0.2	0.2	0.9	1.1	0.7	0.6	0.9	1.2
2019f	0.8	-0.5	0.4	0.2	0.2	0.8	0.9	0.5	0.6	0.9	1.0
Unemployment Rate (%)											
2000–16	7.1	14.3	11.2	8.8	9.6	8.0	7.1	5.1	5.0	5.1	6.6
2016	7.0	13.4	10.7	8.3	9.5	7.1	6.5	6.1	6.3	8.1	6.0
2017f	6.5	14.8	10.0	8.2	8.3	6.2	6.2	5.5	6.2	8.1	5.4
2018f	6.3	15.1	10.0	8.0	8.1	6.0	6.0	5.4	6.0	7.8	5.2
2019f	6.3	15.2	9.9	7.9	8.1	5.9	6.0	5.2	5.9	7.6	5.1
Housing Starts (units, 000s)											
2000–16	199	2.6	0.7	4.3	3.5	44	71	5.1	5.2	34	28
2016	198	1.4	0.6	3.8	1.8	39	75	5.3	4.8	25	42
2017f	212	1.2	0.9	4.1	1.7	42	81	7.2	4.8	29	40
2018f	198	1.1	0.7	3.8	1.8	39	75	6.0	4.7	28	38
2019f	188	1.2	0.7	3.7	1.7	36	71	5.9	4.6	27	36
Motor Vehicle Sales (units, 000s)											
2000–16	1,657	29	6	48	38	413	635	47	45	216	180
2016	1,949	33	9	54	44	458	807	55	51	220	218
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
2019f	1,950	28	7	53	40	444	788	58	61	253	218
Budget Balances, Fiscal Year Ending March 31 (CAD mn)											
2000–16**	-2,803	-75	-38	-30	-153	-821	-5,115	-142	360	1,064	319
2016	-987	-2,207	-13	-13	-261	2,191	-3,515	-839	-675	-6,442	811
2017f	-17,770	-1,080	-18	150 †	-119 †	250	-991 †	-764 †	-1,354 †	-10,784 †	2,737 †
2018f***	-17,000	-778	1	132	-156	0	0	-840	-685	-10,288	246
2019f***	-16,000	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a

Sources: Scotiabank Economics, Statistics Canada, CMHC, Budget documents. * Real GDP by industry at basic prices. ** MB:FY04–FY15; AB:FY05–FY15; SK:FY15–FY18f: ex. accrual adjustment for pension expense. *** Canadian federal forecast for FY18 & FY19 excludes risk adjustment. † Final FY17; other FY17 & FY18: Provinces' estimates.

United States

- **The recent hurricanes will have limited effects on the US economy. Strong employment gains should boost consumption as a driver of the US economic expansion and push growth to 2.2% y/y in 2017, before plateauing in 2018 at 2.3% and decelerating to 1.7% y/y in 2019, close to potential.**
- **The US industrial sector is on track to rise from two years of doldrums, stemming from recovery in the extractive sectors and gains in capital-goods industries as investment picks up across the economy. This rebound could be dampened if federal tax reform fails to materialize.**
- **The concurrent pick-up in global growth should boost US exports in the coming years, but the country's current account deficit will likely widen as imports continue to grow owing to a still-strong US dollar.**

THE MORE VIOLENT THE STORM, THE QUICKER IT PASSES

Hurricanes Harvey and Irma dominated US news in recent weeks, but despite the havoc they wrought in the southern states of the US and Puerto Rico, neither is expected to have a meaningful impact on overall US economic activity. US growth averaged just above 2% in the first half of 2017, and looks set to come in at a similar pace in the second half following the storms (table 1). This steady growth performance, with 2.2% y/y projected in 2017 and 2.3% y/y in 2018 (table 2), nevertheless remains above both the Fed and Scotiabank Economics' estimates of potential growth averaging around 1.8% during 2017–19 (chart 1). Strong consumption growth combined with a rebound in industrial activity should keep the US in excess-demand territory during 2017 and 2018, even if Washington proves unable to deliver on meaningful changes in taxes and spending.

US CONSUMERS REGAIN THEIR MOJO

After a brief early-year lull, consumers are once again leading the US expansion. Solid consumer fundamentals, including a robust job market, should sustain steady consumption growth of around 2.5% through next year. Monthly hiring gains are averaging around 185,000 new positions, a strong performance at this late stage of the economic cycle. Consumer confidence is near 16-year highs.

Wage gains remain muted, but should begin to accelerate given drum-tight labour markets and firming labour productivity trends. Most measures of US labour-market slack imply that the economy is at full employment. The US jobless rate is near a 16-year low of 4.4%, while broader measures of labour underutilization that account for marginally attached and underemployed workers are also plumbing decade-lows. The job openings (JOLTS) rate is near its highest level since at least 2000, evidence of growing labour shortages driven by stronger growth and demand (chart 2).

CONTACTS

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

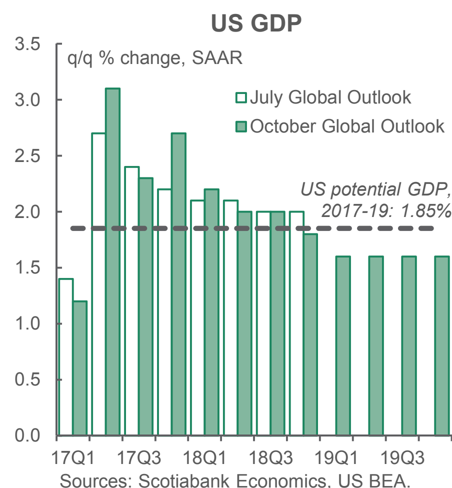
Carlos Gomes
416.866.4735
Scotiabank Economics
carlos.gomes@scotiabank.com

Juan Manuel Herrera
416.866.6781
Scotiabank Economics
juanmanuel.herrera@scotiabank.com

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

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

Chart 1



Sources: Scotiabank Economics, US BEA.

Solid household balance sheets also are providing support to consumer spending. Rising home and equity values have driven household net worth to record levels. Debt-service charges consume about 10% of disposable income, near the lowest level on record. Households have rebuilt significant home equity.

Household vehicle purchases remain resilient, and should continue to move higher in 2018 given an ageing vehicle fleet. The slowdown in overall auto sales this year in large part reflects de-fleeting in the US rental car market. Replacement demand for vehicles damaged by hurricane-induced flooding also will provide a boost to sales into 2018.

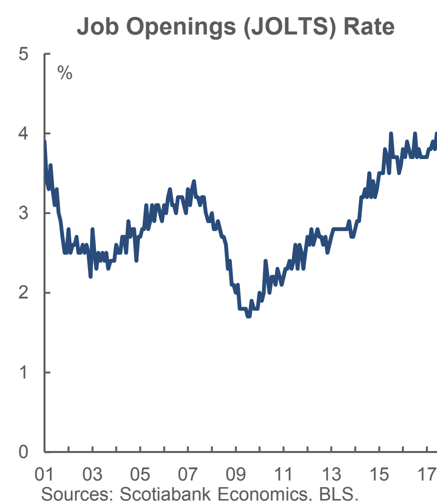
There are a few downside risks to the US consumer outlook. An increasing share of spending is being financed by debt or savings. Growth in consumer credit has more than doubled over the past year to 6% y/y, led by revolving credit. Savings rates have been drawn down, and are nearing pre-recession lows (chart 3). Delinquency rates are turning up for some debt categories, including credit cards. Conversely, the potential for the US administration to implement personal income tax reform remains an upside risk. No significant tax relief is currently built into our forecast.

A MORE MUTED US HOUSING OUTLOOK

The US housing recovery has lost some momentum. Taking into account weaker activity in regions hit hard by recent hurricanes, total existing home sales in 2017 are expected to end the year largely on par with 2016 levels. Housing starts also are expected to be relatively flat year-on-year.

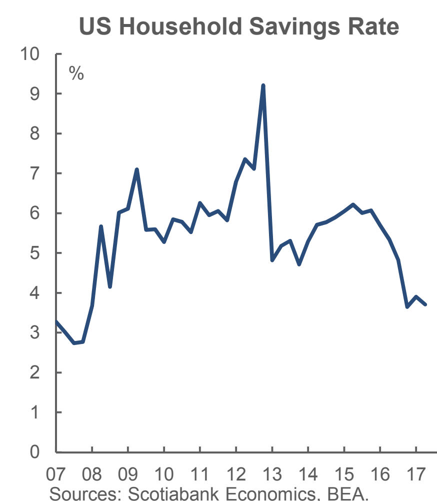
The fundamental drivers of housing demand remain solid, including low borrowing costs, strong job growth, rising incomes, and elevated consumer confidence. Lenders are gradually easing loan standards. Millennials are ageing into their prime home-buying years. In short, there is still considerable pent-up demand for housing. The US homeownership rate, after hitting a record low of 63.1% in mid-2016, is edging higher across age cohorts.

Chart 2



Sources: Scotiabank Economics, BLS.

Chart 3



Sources: Scotiabank Economics, BEA.

Table 1

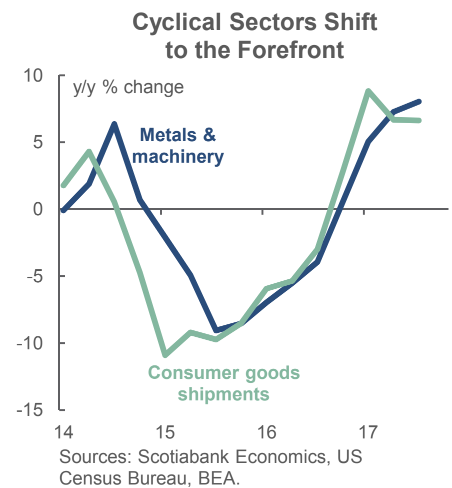
Quarterly US Forecasts	2017			2018				2019			
	Q2	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Economic											
Real GDP (q/q ann. % change)	3.1	2.3	2.7	2.2	2.0	2.0	1.8	1.6	1.6	1.6	1.6
Real GDP (y/y % change)	2.2	2.1	2.3	2.6	2.3	2.2	2.0	1.9	1.8	1.7	1.6
Consumer prices (y/y % change)	1.9	1.8	1.8	1.7	2.1	2.2	2.2	2.2	2.3	2.4	2.4
CPI ex. food & energy (y/y % change)	1.8	1.7	1.8	1.8	2.1	2.1	2.2	2.2	2.2	2.3	2.3
Financial											
Euro (EURUSD)	1.14	1.18	1.18	1.18	1.18	1.20	1.20	1.24	1.24	1.28	1.28
U.K. Pound (GBPUSD)	1.30	1.28	1.33	1.35	1.35	1.37	1.37	1.38	1.38	1.40	1.40
Japanese Yen (USDJPY)	112	110	112	114	114	115	115	118	118	120	120
Fed Funds Rate (upper bound, %)	1.25	1.25	1.50	1.50	1.75	1.75	2.00	2.00	2.00	2.25	2.25
3-month T-bill (%)	1.01	1.04	1.30	1.40	1.60	1.70	2.00	2.05	2.05	2.30	2.30
2-year Treasury (%)	1.38	1.48	1.55	1.75	1.85	1.95	2.10	2.20	2.30	2.35	2.45
5-year Treasury (%)	1.89	1.93	2.00	2.10	2.15	2.20	2.30	2.40	2.50	2.55	2.60
10-year Treasury (%)	2.30	2.34	2.30	2.35	2.45	2.60	2.70	2.75	2.80	2.90	3.00
30-year Treasury (%)	2.83	2.86	2.80	2.80	2.85	3.00	3.10	3.10	3.15	3.20	3.30

Sources: Scotiabank Economics, BEA, BLS, Bloomberg.

Yet, a number of factors are expected to continue to restrain activity. Rising home prices, high student debt loads, and a persistent shortage of affordable listings all remain a significant hurdle for many potential buyers. The number of available existing homes for sale has fallen to historic lows. Market conditions remain most challenging for first-time buyers, whose share of home purchases remains stuck at just over 30%, well below the historical average of near 40%. Rising rates and higher borrowing costs will worsen affordability.

We have downgraded our expectations for new home construction since last quarter's *Global Outlook*. While builder confidence remains high, the ability to ramp up activity more sharply is constrained by rising land prices, higher construction costs, and labour shortages. Housing starts are now expected to total 1.25 and 1.30 mn units, respectively, in 2018 and 2019—up from an estimated 1.20 mn units this year (table 2 again), but still well below underlying demographic requirements estimated at around 1.40 mn units annually.

Chart 4



Sources: Scotiabank Economics, US Census Bureau, BEA.

INDUSTRIAL RECOVERY ACCELERATES

US industrial activity continues to gain momentum. Domestic demand for manufactured products is advancing at its fastest pace since 2011 and business confidence has jumped to its highest level since the start of the millennium. Consumer goods originally led the way, buoyed by a solid labour market and the healthiest household balance sheets in more than a decade. However, the economically-sensitive resource sector and capital goods industries have moved to the forefront of growth in recent months, as both US and global growth consolidates (chart 4). In particular, US demand for metal products has advanced at a 10% y/y pace this year to date, reversing the sharp fall-off we saw through mid-2016. For example, US steel demand has surged by about 18% y/y over the year to date, the best performance since 2011. This improvement reflects enhanced prospects for business investment and construction activity, and should be bolstered by reconstruction efforts and increased federal spending following the recent hurricanes. For context, in the aftermath of 2005's Hurricane Katrina, Congress approved aid packages exceeding USD 100 bn (0.7% of GDP); an even larger stimulus is likely following the latest hurricane season.

BROAD-BASED REBOUND IN BUSINESS INVESTMENT

US business investment climbed an annualized 7% in the first half of 2017, the best performance in three years, which has led to a significant acceleration in machinery demand. As of August, US machinery demand had risen 7% y/y in the year to date, with double-digit gains across most industries. While a 54% y/y rebound in the oil & gas sector activity in the first half of 2017 is providing a major boost to machinery and steel products, non-energy investment is also strengthening, which is helping to lift non-defense capital goods orders at an accelerating pace and points to further improvement ahead in business investment (chart 5). Of note, US demand for construction machinery has surged about 17% y/y so far during 2017, with a similar advance reported in rail volumes for cement and other construction materials. In fact, investment in nonresidential structures is outpacing the growth in capital equipment this year for the first time since 2014. New plant construction has even begun to stabilize, as industrial operating rates have climbed from

Table 2

United States	2000–16	2016	2017f	2018f	2019f
	(annual % change, unless noted)				
Real GDP	1.9	1.5	2.2	2.3	1.7
Consumer spending	2.4	2.7	2.7	2.5	2.1
Residential investment	-0.4	5.5	1.5	1.5	1.6
Business investment	2.3	-0.6	4.4	3.5	2.3
Government	1.0	0.8	0.1	0.7	0.5
Exports	3.6	-0.3	3.2	2.7	2.7
Imports	3.4	1.3	3.8	3.3	3.2
Nominal GDP	3.9	2.8	3.9	4.0	3.7
GDP Deflator	2.0	1.3	1.7	1.7	1.9
Consumer price index (CPI)	2.2	1.3	2.0	2.1	2.3
CPI ex. food & energy	2.0	2.2	1.8	2.0	2.2
Pre-tax corporate profits	5.5	-2.1	4.0	3.4	0.5
Employment	0.7	1.8	1.5	1.2	1.1
Unemployment rate (%)	6.2	4.9	4.4	4.3	4.2
Current account balance (USD bn)	-507	-452	-491	-552	-605
Merchandise trade balance (USD bn)	-673	-753	-816	-883	-952
Federal budget balance (USD bn)	-532	-585	-650	-660	-700
percent of GDP	-3.7	-3.1	-3.4	-3.3	-3.4
Housing starts (mn)	1.27	1.18	1.20	1.25	1.30
Motor vehicle sales (mn)	15.5	17.5	17.1	17.4	17.3
Industrial production	0.7	-1.2	1.5	1.8	1.0
WTI oil (USD/bbl)	63	43	50	52	56
Nymex natural gas (USD/mmbtu)	4.94	2.55	3.08	2.85	3.00

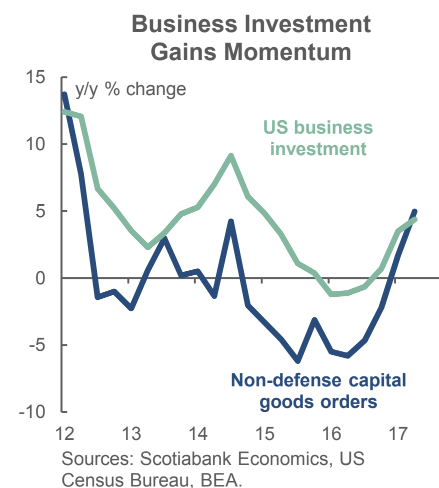
Sources: Scotiabank Economics, BEA, BLS, Bloomberg.

the cycle-low set in the first quarter of 2016. However, profit margins have yet to rebound, held back by sub-par earnings in some key sectors.

STILL, ONLY LIMITED FISCAL STIMULUS ANTICIPATED

The forecast contribution of current and capital spending across all levels of government to annual real GDP growth is projected to edge up to a muted 0.1 percentage point annually in 2018 and 2019. State and municipal governments are responding cautiously to the ongoing volatility in federal policy discussions given the Republicans' wish to devolve more program responsibility to lower levels of government. We assume a moderate widening of the federal fiscal deficit from a low of 2.4% in fiscal 2015 to 3.3% in fiscal 2019 as revenue growth fails to keep pace with annual expenditures that are being pushed up by net interest payments, mandatory outlays, and significant one-time events.

Chart 5



Sources: Scotiabank Economics, US Census Bureau, BEA.

Fiscal policy would be broadly more stimulative if some combination of the Republicans' proposed corporate and personal income-tax reforms is eventually legislated. Some of the US administration's key proposals are summarized below, though we acknowledge that critical supporting details are not known. Proposed tax relief for citizens includes: collapsing the existing seven federal personal income tax brackets to three (i.e., 12%, 25%, and 35%), with the option of a fourth bracket for the very highest earners; expanding the standard deductions, enhancing the child tax credit; and eliminating the Alternative Minimum Tax and the Estate Tax. For corporations, the federal income tax rate would be trimmed from 35% to 20%, and for small businesses that pass through profits to their owners, the tax rate would be 25%. For five years, investment in machinery and equipment could be fully written off in the first year. For multinationals operating abroad, the current worldwide tax would be replaced by a territorial system.

Details on the means by which these tax cuts would be financed, however, remain to be determined by Congress. Representatives are unlikely to agree to eliminate several key deductions, notably those provided on mortgage interest, charitable donations, and state and local taxes, to finance tax reform. As a result, the recently proposed package of reforms is unlikely to succeed, but its failure could spur some interim stop-gap measures in order for the White House and legislators to show some progress.

EXPORTS RISE, BUT TRADE DEFICITS SET TO WORSEN

American merchandise exports have posted their largest annual gains in half a decade, supported by a substantial recovery in commodity exports and renewed strength in manufactures. Higher oil and minerals prices have lifted growth in mining, petroleum, and coal exports to a 45% y/y average in the year to July. Last year, these exports shrank at a yearly pace of 22% over the same period; their current levels remain at around three-quarters of the export flows that prevailed prior to the 2015 oil crash. Overall, total goods exports have grown by 7% y/y as of July, surpassing the 4.1% y/y gains over the same period in services exports—the first time this has happened since 2012, thanks mainly to the recovery in the mining sector.

Still, persistent strength in the USD—which remains near post-recession highs, supported by capital inflows in response to the Fed's efforts to normalize monetary policy—should keep merchandise imports growing faster than exports. While the surplus on services trade has remained relatively constant since 2014, a recent 8% y/y increase in the goods trade deficit has contributed to a slight widening of the country's current account deficit (chart 6). The US's trade and current account deficits will likely continue to expand with savings rates at pre-recessions lows (chart 3 again) and the US Administration pushing to provide additional fiscal stimulus through infrastructure spending or tax cuts—thereby undermining one White House priority while delivering on another.

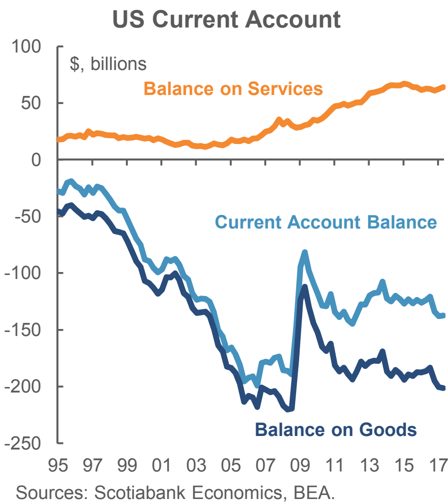
FOREIGN PURCHASES OF US SECURITIES RETURN

In international financial markets, net foreign purchases of US securities have remained in the black for seven consecutive months, the longest streak since 2012–13, after oscillating between net outflows and net inflows nearly every month since mid-2015 as China reduced its reserve holdings of US Treasuries (chart 7). In the year to July, Chinese holdings of US Treasuries have recovered by some USD 117 bn as pressure on the Chinese authorities to support the yuan have eased. Foreign purchases of domestic corporate stocks and fixed-income instruments have also picked up over the last 18 months in the search for yield (chart 8).

THE RISKS OF AMERICAN EXCEPTIONALISM

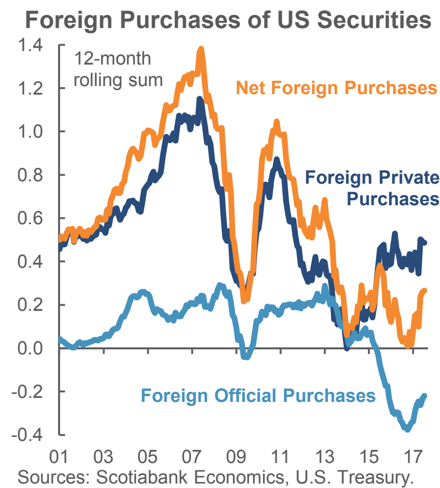
Some aspects of the uncertain policy terrain in the US have firmed up in recent months, while others have become softer. The deal between the White House and Congressional Democrats put a temporary end to the debt-ceiling debate, but this issue could flare anew in 2018. The recent collapse of successive health-care reform bills exemplifies how the divided Republican-controlled Congress may also find it difficult to pass meaningful tax reform or major spending initiatives—which could put a halt on the emerging rebound in business investment. Growth could be further stifled by protectionist efforts to crimp the North American Free Trade Agreement (NAFTA), and stifle trade in, amongst other things, aircraft, lumber, aluminum, steel, and solar panels.

Chart 6



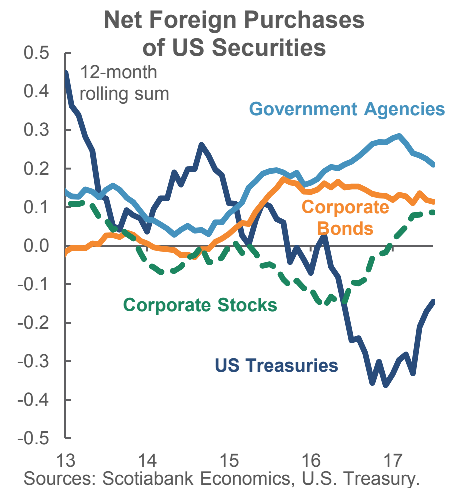
Sources: Scotiabank Economics, BEA.

Chart 7



Sources: Scotiabank Economics, U.S. Treasury.

Chart 8



Sources: Scotiabank Economics, U.S. Treasury.

US & Canadian Monetary Policy & Capital Markets

Scotiabank Economics has not materially altered its forecasts for the Federal Reserve, Bank of Canada and broader yield curves. One more hike from each central bank this year is still expected to be followed by two more hikes from each next year in such fashion as to continue bear flattening the 2s10s slopes of each country's yield curve as a neutral influence upon CAD (charts 1, 2). We forecast a constant overnight rate spread of -25bps over our forecast horizon with policy rates coming close to if not converging upon neutral rate assumptions in 2019.

BANK OF CANADA — PAUSE, THEN GRADUAL

The BoC is expected to hike by 25bps in December and twice more in 2018 around April and October timelines. In timing the next hike, the risk is skewed toward later than December rather than sooner. By 2019, a neutral policy rate range of 2–2.5% is forecast for this cycle.

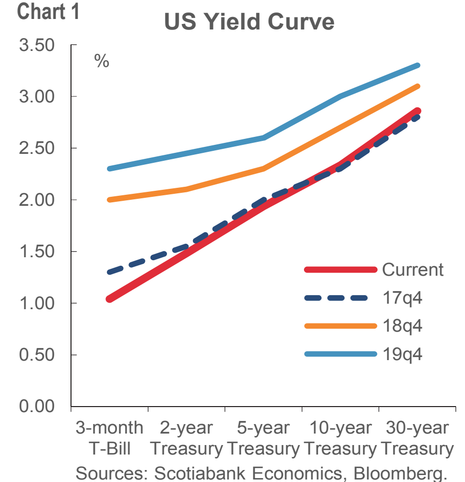
Governor Poloz's recent speech and press conference continue to leave the door open to further rate hikes while also indicating some patience and data dependence (here). In reference to how tightening involves more than just reversing the two cuts in 2015, Poloz stated that "At a minimum, that additional stimulus is no longer needed." Briefly summarized, a pause was signalled by a) stating that the BoC will "feel our way cautiously", b) indicating nothing "mechanical in our approach to monetary policy" which leans against a straight line of uninterrupted policy moves in anticipation of model-based developments, c) flagging still-soft wage data, d) indicating uncertainty over the investment cycle and its influences upon spare capacity and hence inflation pressures, and d) indicating uncertainty toward the "cause, size and persistence" of currency movements and associated effects.

The reasons for a tightening bias continue to include:

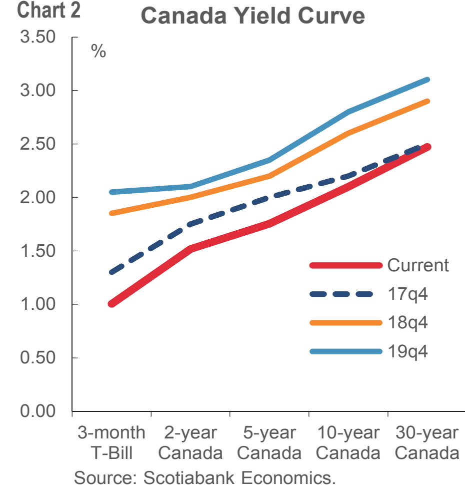
- The lifting of domestic idiosyncratic inflation drivers as prices for gasoline, autos and electricity turn from being disinflationary toward reflationary;
- The general output gap framework as spare capacity has largely closed on the back of strong growth while we anticipate that a slower-growing economy will slip marginally into excess aggregate demand going forward. With the customary lag, a mild rise in inflationary pressure is anticipated (chart 3).
- Event risk has subsided. It appears unlikely a) that the US will impose border taxes, b) that NAFTA will be a major macro-event as opposed to a sector-specific consideration, and c) that Canada will import a major bond market shock from the US on the application of fiscal and regulatory stimulus late in the cycle while the term premium rises as the Federal Reserve's balance sheet shrinks (more on this below).
- Financial stability risks. The corrections in Vancouver's and Toronto's housing markets will likely prove to be temporary and motivate further comfort toward tightening at a gradual pace. Indeed, household credit growth has accelerated over the summer.

CONTACTS

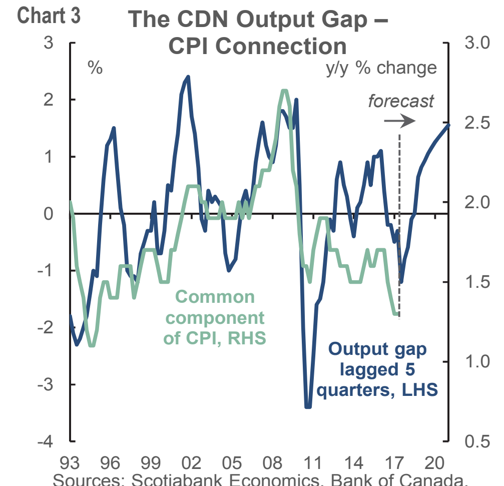
Derek Holt, VP & Head of Capital Markets Economics
416.863.7707
Scotiabank Economics
derek.holt@scotiabank.com



Sources: Scotiabank Economics, Bloomberg.



Source: Scotiabank Economics.



Sources: Scotiabank Economics, Bank of Canada.

- To sterilize a fiscal policy overshoot. The combined application of monetary and fiscal policy stimulus led to stronger-than-expected GDP growth averaging nearly 4% over the past four quarters in inflation-adjusted terms.

FEDERAL RESERVE — CONVENTIONAL TIGHTENING

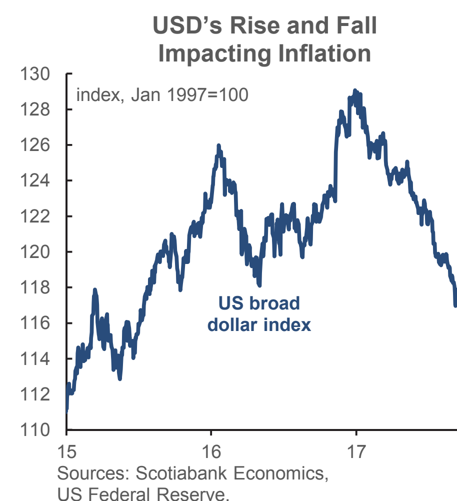
A rate hike in December is expected to be followed by two more hikes in 2018 around June and December timelines and hence one less than the Fed's 'dot plot' guidance. We then anticipate that a neutral policy target range of 2.25–2.5% will be realized into 2019 as the rate hike cycle comes to a close.

There are at least three main considerations that are guiding our forecast beyond the underlying growth and spare capacity fundamentals that we think support further hikes.

1. Inflation And The Dollar

Inflation is probably undergoing transitory headwinds related to past USD strength. As the USD has weakened since spring, **a higher inflation profile is anticipated and this should support a return to policy tightening**. While the connection between the dollar and inflation is hardly air-tight, large, abrupt swings in the dollar tend to be more correlated with large, abrupt swings in import prices (chart 4) and modest pass-through to CPI. The broad dollar index is now at its lowest since April 2016 and has reversed all of the pre- and post-election rally and then some. A more muted correction in the dollar in early 2016 was followed by a rise in core PCE inflation from about 1.2% y/y to 1.9% y/y with several drivers, the USD among them.

Chart 4



Sources: Scotiabank Economics, US Federal Reserve.

It is important to recall the literature and to note that the Federal Reserve views the currency's role in this way. Indeed this speech about two years ago by retiring Vice Chairman Stanley Fischer was specifically on the very topic of exchange rate effects on growth and inflation. Fischer stated that Fed models indicate that for every 10% trade-weighted appreciation in the dollar, core PCE inflation is reduced by 0.5% in the two quarters following the dollar's move and the four-quarter effect is to reduce core PCE inflation by about 0.3%. Note that the broad dollar index appreciated by about 9% from the spring of 2016 until early 2017 and has since depreciated by a similar amount.

It is therefore conceivable that much of the deceleration in core PCE inflation from 1.9% at the start of this year to 1.4% as of August was due to the dollar's prior appreciation. **By corollary, dollar depreciation since earlier this year may well have the Fed much closer to its inflation target as soon as 2018H1.**

2. Rely On Conventional Tightening

As explained in the yield curve forecasts below, it's unlikely that the Fed will be able to singlehandedly cheapen the Treasury curve through raising the term premium via reduced reinvestment. Thus, **unconventional policy tightening is no clear substitute for conventional policy tightening**. It therefore remains unclear that the Fed should count upon unconventional tightening in lieu of conventional rate hikes as some FOMC officials appeared to suggest or implied comfort toward over the summer.

3. Sterilizing Other Policy Stimulus

Will potential fiscal and regulatory policy easing be achieved in such fashion as to offer meaningful macroeconomic benefits? This is a hugely loaded question that present space is not suited to addressing in full, but our assumption is that there will be very little macroeconomic benefit to potential policy reforms. If we're wrong then markets and Federal Reserve policy may sterilize the outcomes which means **the Fed's response to fiscal policy initiatives ranges between being relatively benign to incrementally hawkish relative to our base case scenario.**

One argument not on this list of key considerations is that FOMC officials desire policy tightening in order to build future policy flexibility away from the lower bound on rates should downside risks to the economy and the Fed's dual mandate resurface. There may be some who believe this, but the embedded circular logic is that the Fed wishes to court recession risks through policy tightening that is otherwise unsuitable so that it has the flexibility to counter the next recession.

YIELD CURVES — ASYMMETRIC TERM PREMIUM RESPONSE?

A key issue governing the outlook for the yield curves (see table) is whether the Treasury term premium rises as the Fed reduces its balance sheet holdings of Treasuries and MBS and at what pace. I think the term premium will rise more slowly as the balance sheet shrinks than it fell as QE expanded the balance sheet over the post-crisis period. That doesn't mean Treasuries can't cheapen further from here over the next year, with our forecast being that US 10 year yields end 2018 at about 2¾%, but added pressures from a big rise in the term premium are unlikely in my view.

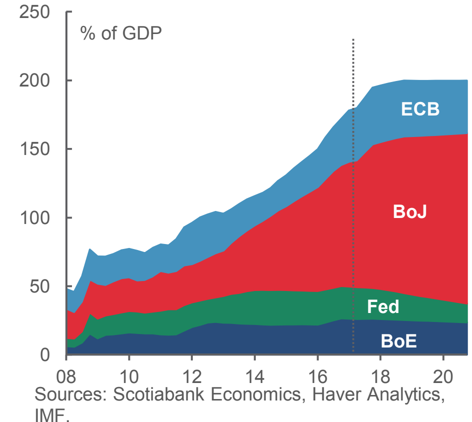
Research (here) suggests US 10 year Treasury yields are about 1% lower than where they would be otherwise in the absence of the Fed's balance sheet expansion and controlling for other influences. The view that the Treasury term premium will rise less materially than it fell (i.e., a shallow 'U' versus a 'V') is based upon many other considerations affecting the Treasury market than just the Fed's balance sheet that have markets understanding the reduction plan but in the context of other considerations. They include:

- Late cycle concerns that could slow, halt or reverse balance sheet reduction plans at some point along the multi-year plan. There is practically zero science around timing a business cycle but the risks of disappointment somewhere along the way are more material when one is dealing with the third longest expansion on record that will soon become the second longest than they would be if the expansion were at a more embryonic stage;

- The actions of other major QE central banks whose balance sheets will not be shrinking for years (BoE) or will continue to expand even if at a slower pace in future (ECB, BoJ). Please see chart 5. This is unlike the taper tantrum in May 2013 in that other central banks were nowhere nearly as active including the ECB whose balance sheet was shrinking at the time. The estimate of the term premium's reduction via the Fed's QE program was also skewed toward a period when QE1 and QE2 were rolled out before much more aggressive foreign central bank actions on conventional (negative policy rates) and unconventional (QE, guidance, term lending programs, etc.) policies. The ability of the Fed to cheapen the Treasury market on its own is limited in a world of connected carry trades adjusted for FX hedging risks if other foreign central banks are still hesitant to allow their own yields to rise materially.

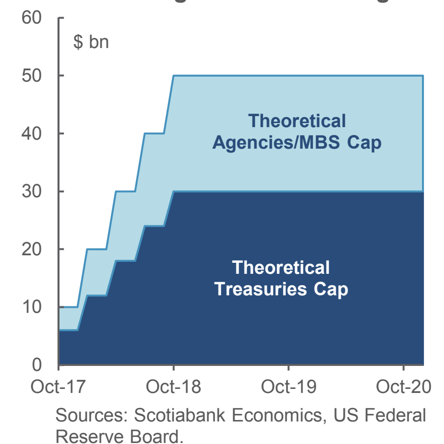
- Elevated stock markets may merit a safe-haven bid that preserves demand for Treasuries.

Chart 5



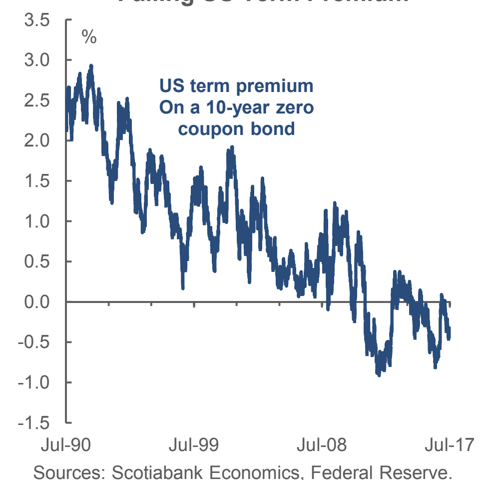
Sources: Scotiabank Economics, Haver Analytics, IMF.

Chart 6



Sources: Scotiabank Economics, US Federal Reserve Board.

Chart 7



Sources: Scotiabank Economics, Federal Reserve.

- The reinvestment caps (chart 6) are theoretical and not binding. The actual amounts allowed to roll off the balance sheet each month depend upon the flow of maturing securities and, in the case of MBS, prepayments risk. Starting about a year from now, there will be several months each year in which the actual amount of Treasuries maturing and rolling off the balance sheet will be materially lower than the theoretical investment caps.

- Neutral rate estimates continue to move lower and are the ultimate anchor for the curve's pricing of potential future Fed rate policy actions.

- There are various other influences upon the term premium that has been dropping for decades and well before QE, like estimates of long-run inflation risk (chart 7). On that note, the 5y5y inflation swap is pricing longer-run inflation of 2.3% at the moment which seems fairly reasonable at this point.

Table 1

Scotiabank Economics' Canada-US Yield Curve Forecast

	2017		2018				2019			
	(end of quarter, %)									
Canada	**Q3**	**Q4f**	**Q1f**	**Q2f**	**Q3f**	**Q4f**	**Q1f**	**Q2f**	**Q3f**	**Q4f**
BoC Overnight Target Rate	1.00	1.25	1.50	1.50	1.75	1.75	2.00	2.00	2.00	2.00
Prime Rate	3.20	3.45	3.70	3.70	3.95	3.95	4.20	4.20	4.20	4.20
3-month T-bill	1.00	1.30	1.55	1.60	1.80	1.85	2.05	2.05	2.05	2.05
2-year Canada	1.52	1.75	1.85	1.90	1.95	2.00	2.05	2.05	2.10	2.10
5-year Canada	1.75	2.00	2.05	2.10	2.15	2.20	2.25	2.25	2.30	2.35
10-year Canada	2.10	2.20	2.25	2.35	2.45	2.60	2.70	2.75	2.80	2.80
30-year Canada	2.48	2.50	2.55	2.60	2.75	2.90	2.95	3.00	3.05	3.10
United States	**Q3**	**Q4f**	**Q1f**	**Q2f**	**Q3f**	**Q4f**	**Q1f**	**Q2f**	**Q3f**	**Q4f**
Fed Funds Target Rate	1.25	1.50	1.50	1.75	1.75	2.00	2.00	2.00	2.25	2.25
Prime Rate	4.25	4.50	4.50	4.75	4.75	5.00	5.00	5.00	5.25	5.25
3-month T-bill	1.04	1.30	1.40	1.60	1.70	2.00	2.05	2.05	2.30	2.30
2-year Treasury	1.48	1.55	1.75	1.85	1.95	2.10	2.20	2.30	2.35	2.45
5-year Treasury	1.93	2.00	2.10	2.15	2.20	2.30	2.40	2.50	2.55	2.60
10-year Treasury	2.34	2.30	2.35	2.45	2.60	2.70	2.75	2.80	2.90	3.00
30-year Treasury	2.86	2.80	2.80	2.85	3.00	3.10	3.10	3.15	3.20	3.30

Sources: Scotiabank Economics, Bloomberg.

Mexico

MIXED SIGNS WITH A POSITIVE BALANCE

- **Mexico is grieving the losses suffered as a consequence of two terrible earthquakes in September. It is still too early to determine the likely effects on the macroeconomic landscape, but we think they will be relatively small.**
- **Some of the recent economic indicators present conflicting results that could imply the Mexican economy is slowing down; while others point the other way. We see the positive balance prevailing, and thus we are once again raising our GDP forecasts**.
- **Contrasting with the market's view that monetary policy will be rapidly eased in 2018, we still expect Banco de Mexico to increase its reference interest rate a couple more times**.

September was a disastrous month for Mexico. Two strong earthquakes produced terrible human losses and severe damage, mainly in the center-south region, affecting Mexico City, Puebla, State of Mexico, Oaxaca, Chiapas and Morelos. There is not yet a final assessment of the devastation, but the death toll across the country is more than 330. In Mexico City alone, over 3,000 buildings were damaged and 40 buildings collapsed. Most of productive infrastructure was not seriously affected, even though some sections of the highway between Mexico City and Acapulco were destroyed and the Salina Cruz refinery in Oaxaca was shut down for some weeks.

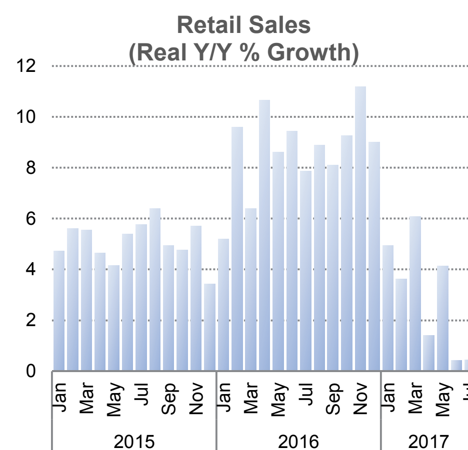
It is difficult to assess the impact on the macroeconomic variables, but in our view, effects on economic growth and inflation will be barely observable and transitory. Our preliminary estimate of the impact on third quarter GDP growth is less than 0.2 percentage points, not affecting the growth forecast for the whole year. Inflation could reveal some pressures as the unusual demand for several products increased and business inventories fell. Some other price increases could be observed during the reconstruction phase, especially in construction materials such as cement, steel, glass, etc. In any case, these pressures will be temporary and are not expected to have a material impact on inflation.

Turning to the economy, there are currently some mixed signals that are difficult to interpret. Retail sales are showing a significant slowdown (see chart 1), barely growing in real terms on a y/y basis in June and July. Much of this slower pace is explained by the weakness in auto sales (-4.8% y/y in June and -4.3% y/y in July), and departmental stores and supermarkets (-0.9% y/y in June and -0.1% y/y in July). There are, however, strong increases in health care items (+7.4% y/y), paper and leisure products (+8.0% y/y), home appliances and computers (+11.0% y/y) and TV and e-commerce (+10.3% y/y), all of them in July. Worth noting is that some of the slowdown is explained by the unexpected acceleration in inflation.

CONTACTS

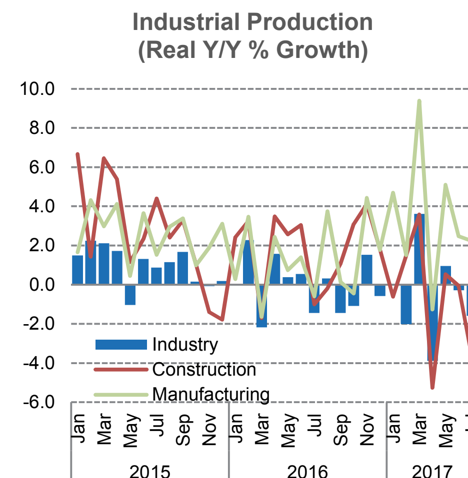
Mario Correa
52.55.5123.2683 (Mexico)
Scotiabank Mexico
mcorrea@scotiacb.com.mx

Chart 1



Source: INEGI

Chart 2



Source: INEGI

Industrial activity also performed poorly, falling 1.6% real y/y in July, showing contractions in mining (-8.6%), utilities (-2.7%) and construction (-3.7%), from which the housing and commercial construction fell 4.4% real, an unusual development for this sector. On the other hand, manufacturing industry grew 2.2% real y/y in July, with some unusual contrasts among some of its components, which suggest there could be some specific unidentified factors affecting the numbers: while oil and carbon derivatives fell 22.7% real y/y, production of machinery and equipment grew 32.0% real y/y (!).

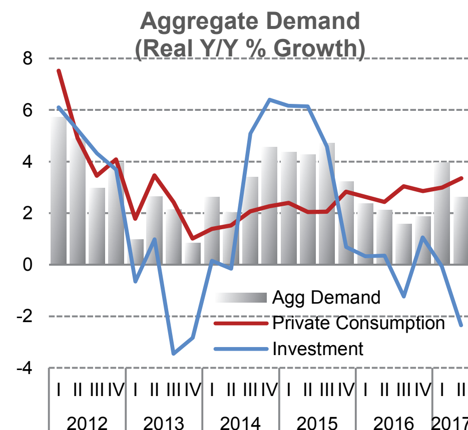
On the positive side, job creation, as measured by the number of workers insured at the Mexican Social Security Institute, reached 676 thousand year to date in August, averaging 4.3% y/y growth, while the unemployment rate reached 3.53%, the lowest for such a month since 2002.

Remittances from abroad reached an accumulated figure of US$ 16.4 billion in January–August, growing 6.4% y/y and representing MXN 314.7 billion. This influx is a relevant component of many households' spending within the country.

Private consumption grew 3.4% real y/y in July, which represents a healthy pace. On the aggregate supply and demand figures recently released, total demand presented a significant slowdown in Q2, heavily influenced by the "Semana Santa" (Easter Week) seasonality (see chart 3). Private consumption keeps accelerating despite this effect, growing 3.4% real y/y, which reveals some strength in the internal market. Investment, on the other hand, fell 2.4% real y/y, affected by a confluence of factors, including the "Semana Santa" effect, the public investment cuts to strengthen the fiscal stance, and the likely increase in uncertainty levels due to the new government in the USA and the coming change of government in Mexico next year.

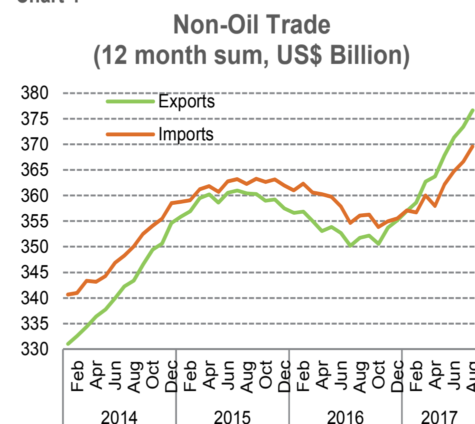
A very positive performance on external trade has been observed during the year. Non-oil exports reached US$ 376.6 billion in the 12 month accumulated sum in August, growing 7.0% y/y, while imports reached US$ 369.6 billion and expanded by 3.8% y/y. Chart 4 shows the positive reaction of trade during the last year. Most of this result is explained by the relative strength showed recently in the US economy.

Chart 3



Source: INEGI

Chart 4



Source: INEGI

On balance, we still perceive the Mexican economy to be on a positive track, and as a consequence, we are once again revising our macroeconomic scenario toward a faster pace of growth. GDP growth for 2017 is revised to 2.4% from 2.0% in the previous quarterly report. For the coming two years we still expect a gradual additional improvement, with a 2.7% GDP growth forecast for 2018 and 3.1% for 2019.

A special comment should be made about our interest rate forecast. Most analysts expect that Banco de Mexico will cut interest rates in 2018. However, inflation has been on the rise, and even though we share the view that inflation will begin a rapid decline during 2018 once the shocks observed during 2017 fade away, we anticipate that inflation will be higher than expected in 2017 and then will not fall below 4% during 2018. There are some concerning signs that could be interpreted as demand-side pressures, for instance, tuition fees keep accelerating, reaching 4.74% in the first half of September. Since inflationary risk keeps rising, we still believe Banco de Mexico will need to make a couple more hikes to the reference interest rate, one this year and another early next year.

A final comment should be made about the political landscape in Mexico, now that the electoral process has formally begun. In the coming months, no later than February 22nd, candidates should be appointed, and a fierce struggle within most parties is expected. Banco de Mexico will have a new Governor, and one likely candidate is the current Minister of Finance, José Antonio Meade, who could also become the PRI presidential candidate. There will be a lot of changes and uncertainty in the coming months, and depending on the final outcome, expect some financial market volatility.

United Kingdom

- **The Bank of England has flagged that a rate hike is likely to be delivered at the next meeting in November.**
- **We expect moderate further tightening to be delivered during 2018, helped by accelerating growth and wage inflation in the new year.**
- **We expect inflation to rise slightly further in the near term (to above 3% y/y), before slowing fairly abruptly during 2018.**

WHAT'S NEW?

The most striking change over the past month has been the change in the Bank of England's tone. The latest Monetary Policy Committee (MPC) minutes were clearly hawkish and the recent data flow has been upbeat. The combination of both makes a rate hike at the November meeting appear almost certain.

Thus far, the MPC has been prepared to tolerate inflation somewhat above target, justified by there being a reasonably wide margin of spare capacity. However, the Bank's view is that the margin of spare capacity is being eroded more quickly than expected—not least because of the latest downwards surprise in the unemployment rate. The BoE also recently judged that the potential growth rate in the UK has slowed, making it easier for slack to be eroded. Last but not least, near term inflation prints have exceeded BoE expectations and the committee judges that wage inflation is probably more buoyant than the official data imply. Both suggest that inflation will continue to exceed the Bank's inflation target. The bottom line is that the committee's tolerance is wearing thin and the first rate hike is imminent.

The next consideration is whether this rate move is the first of several, or merely a reversal of last August's emergency rate cut in the aftermath of the EU referendum result. We suspect that there will be further increases in Bank Rate during 2018, though the data will dictate the timing. Our view is that the MPC will be opportunistic; clawing back interest rate ammunition when the activity data appear strong enough to support such moves. In that context, we doubt that the data will support a second rate hike as soon as the February "Super Thursday" MPC meeting. However, towards the middle of the year we would expect concrete evidence of accelerating wage inflation and an upwards path in GDP growth to pave the way to further increases in Bank Rate.

GROWTH

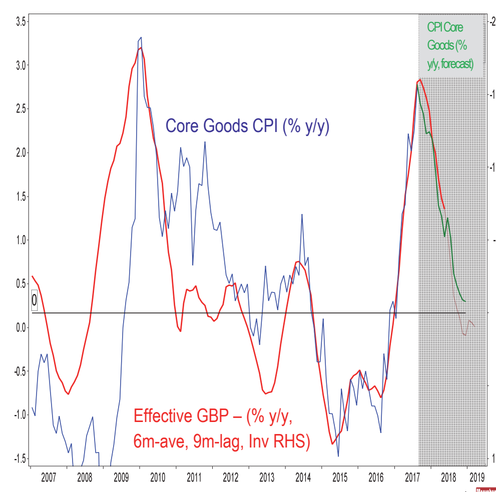
We expect a mediocre GDP reading during Q3; around 0.3% q/q. That would be slightly below the Bank of England's new judgement of trend growth (around 0.4% q/q) but in line with its own forecast of 0.3% q/q for Q3. The headwinds facing the consumer have intensified in recent months; with inflation accelerating further and wage inflation no higher. This should persist until early next year, helping to keep growth at a dreary ¼% q/q in Q4-2017 and Q1-2018.

CONTACTS

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

Chart 1

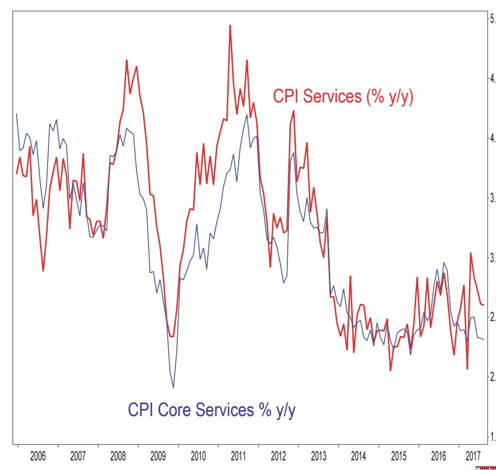
Trade weighted GBP exchange rate versus the most exchange rate sensitive components of the CPI



Sources: Macrobond, Scotiabank.

Chart 2

Core services inflation suggests that domestic pricing power is lacking



Sources: Macrobond, Scotiabank.

Next year should be a better year for growth, depending on which figure you look at. We expect the quarterly growth rates to be on an upwards trajectory throughout 2018, rising from ¼% q/q in early 2018, up to around ½% q/q by the end of the year. While we view that as an improvement, it would translate into an annual average growth rate of 1¼% y/y—somewhat lower than the latest BoE projection.

The shape of our growth profile is heavily influenced by the consumer. The downwards path for growth in 2017 has been almost entirely due to the squeeze on household real disposable income growth, in turn due to accelerating inflation set against sluggish wage inflation. That should reverse during 2018 as inflation decelerates and wage inflation gains traction. Investment and net trade have threatened to prop up growth, but thus far there has been little evidence of this. That is likely to be a reflection of uncertainty, both given the Brexit process as well as the muted pace of GDP growth. We doubt that will change any time soon.

INFLATION

We believe that the peak in inflation is imminent. Virtually all of the acceleration in inflation over the past year has been due to sharply rising imported inflation. However, as chart 1 illustrates, this uplift should be coming to an end very soon. We expect CPI inflation to peak at around 3.1% y/y in September and October—triggering a letter from the BoE Governor to the Chancellor to explain why inflation is so far above target and what the MPC plans to do to remedy the situation. This is largely symbolic and should not rock the boat.

Moreover, we expect inflation to decelerate fairly abruptly over the subsequent 12 month period, particularly as the uplift from imported inflation begins to unwind. Indeed, our forecast for CPI inflation for next year is a reasonable margin below the BoE's latest forecast. We believe that there is a good chance that CPI inflation will undershoot the 2% y/y target by late-2018, particularly in light of the recent appreciation in the GBP exchange rate. This view is somewhat at odds with the market, which seems to be taking the view that inflation will be sticky and take much longer to gravitate back towards the 2% target. The complete lack of acceleration in domestically generated inflation (gauged in chart 2, via core services inflation) suggests to us that pricing power is lacking. As such, we take the view that second round effects from the sharp increase in imported inflation will be less than others have assumed.

ANY OTHER BUSINESS

Wage inflation, or the lack of it, is going to be a major determinant of how soon we should expect to see another rate hike (assuming the BoE does deliver a rate rise at the next meeting). Despite the low headline rate of wage inflation, the BoE has judged that composition effects (a reduction in the proportion of high-pay employees relative to an increase in the proportion of low-pay workers) is distorting the wage inflation figures lower. While the MPC is likely to look through the muted wage data for now, we suspect that they will want to await news of how private sector pay settlements perform at the start of the calendar year before hiking rates further. A 42-year low in the unemployment rate, sharply higher CPI and RPI inflation and anecdotal reports of less plentiful availability of migrant workers all point to some upwards drift in pay growth. Meanwhile the lack of productivity growth and multiple demands on corporate cashflow (apprenticeship levy, auto-enrolment in pensions, national living wage, etc.) are still cannibalising firms' ability to increase pay growth. As such, we have aimed moderately higher for wage inflation next year, consistent with only moderate policy tightening.

Eurozone

- **We expect that eurozone GDP growth will continue accelerating and could even hit 3% y/y by the end of the year.**
- **Inflation is poised to decelerate over the remainder of the year, and could briefly fall below 1% y/y early in 2018.**
- **Against the backdrop of inflation substantially below the 2% threshold, the ECB is likely to continue its programme of asset purchases through 2018, albeit at a decelerating pace.**

GROWTH

Eurozone survey indicators are still extremely elevated and accommodative financial conditions suggest that they should stay that way at least until the end of the year. In turn, this should mean that GDP growth continues to accelerate throughout 2017. On paper, the relationship between output and survey indicators suggests that GDP growth could approach 1% q/q, 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%. The consensus and the ECB have belatedly shifted higher—albeit grudgingly. 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 expect growth of 2.3% y/y in 2017, followed by 2% growth in 2018.

The buoyancy of growth seems to be reasonably broadly based, both on a country-by-country basis and by expenditure component. By country, Spain is leading the charge with growth in excess of 3% y/y. Germany is not far behind and should hit 2½% y/y by end-year. By component, the outlook for consumption is solid, while upbeat manufacturing surveys point to accelerating investment.

INFLATION

Headline inflation has oscillated between 1.5% and 2% y/y so far this year. However, we expect inflation to decelerate over the remainder of the year and could briefly dip below 1% y/y early in 2018. Much of this deceleration is likely to be due to unfavourable petrol price base effects, which should subtract 40bp from overall inflation (in the absence of any sharp gyrations in the price of oil).

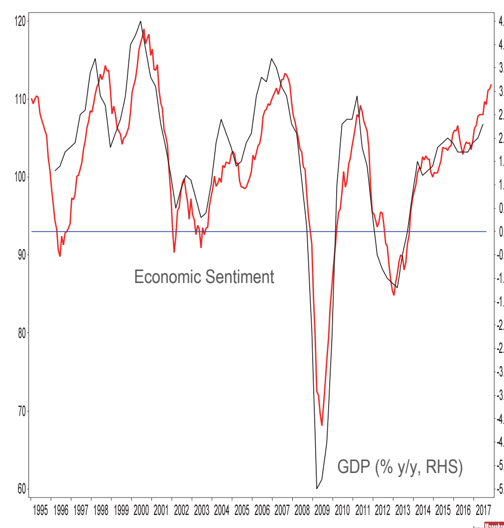
Meanwhile, core inflation has clawed its way back up to 1.2% y/y and we would expect that pace to remain broadly stable from now through 2018. Underlying inflation is facing conflicting influences. On the one hand, robust above-trend GDP growth and falling unemployment suggest that slack is narrowing—arguing for faster core inflation. Meanwhile, the near 8% appreciation in the trade-weighted EUR exchange rate over the past 4–5 months points to downward pressure on underlying inflation. We suspect that these two opposing forces will largely cancel one another out, leading to sideways drift in core inflation through 2018.

CONTACTS

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

Chart 1

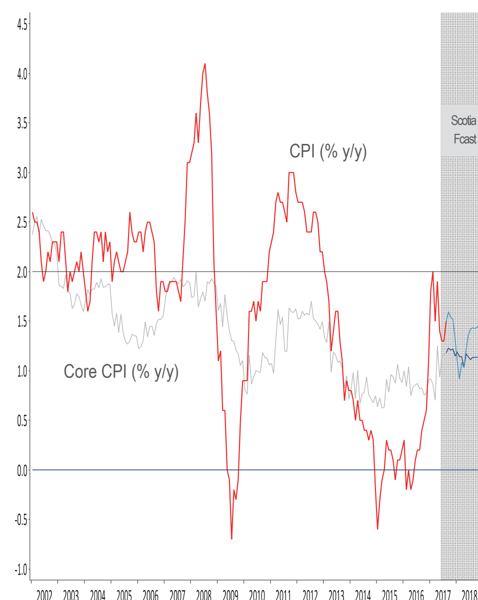
Eurozone economic sentiment vs GDP growth



Sources: Macrobond, Scotiabank.

Chart 2

Eurozone inflation



Sources: Macrobond, Scotiabank.

Given our view that core inflation will drift sideways, headline inflation will be at the mercy of non-core components; namely food and energy. In the absence of sharp swings in energy and food, headline inflation is likely to reside between 1% y/y and 1½% y/y over the course of 2018 before gaining further ground towards the 2% y/y target during 2019.

POLICY

Against that backdrop, the ECB will have to weigh up the competing influences of above-trend GDP growth versus subdued inflation. Since the ECB's mandate is to control inflation, we suspect that the latter will take precedence. As such, we would envisage that the Governing Council will announce a further expansion of its asset purchase programme once the current programme expires in December. We would expect the pace of asset purchases to be halved (i.e. tapered), down from EUR60bn per month to EUR30bn per month. That would probably rule out any tightening in the ECB refi rate at least until 2019.

Political risk in the eurozone has faded and was the dog that didn't bark, let alone bite during 2017. The Dutch, French and German elections all passed without any major market-moving outcomes. The Italian election (most likely in 2018) could cause some jitters, but the worst of the political risk in the Eurozone seems to have been averted.

Brazil

- **A combination of reform progress (in which we think the TJLP changes are particularly relevant—even if we expect a gradual impact), the Brazilian Central Bank's revamped credibility, and a stabilization in public finances has allowed rates to drop quite substantially. This in turn is giving the highly indebted economy some relief, and is boosting consumer spending by freeing up disposable income. However, there are still some risks to this rates compression, which are to a large degree linked to politics.**
- **On the political front, there are two main sources of uncertainty: the 2018 Presidential elections, and whether the government will be able to approve the key reforms. In our view, the most important reform will be pensions, which is highly relevant for the country's fiscal sustainability, but it may also play an important part in next year's presidential elections because given its unpopularity, approving pensions reform could open the way for the PT to defeat the reformers.**

There are many important questions about Brazil as we head into the close of 2017, and most of them come down to politics. However, there is also some uncertainty over when the economy will start posting a more sustained recovery, as well as what will drive it. Regarding the growth rebound, we see some scope for base effects and a recovery in confidence to drive an improvement, but those two factors alone are unlikely to support a sustained recovery. Household spending has been heavily burdened by high indebtedness (see chart 1), but some relief is coming in the form of lower interest rates, which should continue helping alleviate the debt service burden families face. Are lower interest rates sustainable? Our take is there are many moving parts. The BCB has successfully brought inflation back under control, which is allowing it to cut interest rates quite aggressively (the SELIC rate has been cut from 14.25% to 8.25% since October 2016). We and markets expect further cuts, but there is the risk that if reforms are not passed, we could see investor disappointment put the currency (BRL) under depreciating pressures, and push inflation higher.

On a more structural trend, we see room for the reform of the TJLP rate allowing Brazil's market clearing rates to decline. The reason is that it should help de-segment local lending markets, by bringing tier-1 borrowers back into the pool (BNDES had essentially taken tier-1 borrowers out of the market), thus lowering clearing rates. This positive factor should play out gradually. Finally, there is a fiscal aspect to lower rates. Over recent years, the rapid deterioration of Brazil's fiscal position drove the loss of its investment grade rating, and put upward pressure on rates. However, even though the deficit is still wide (we could see a public deficit of around 6% of GDP this year) and the overall debt load is high (gross public debt is rapidly converging to 90% of GDP), the pace of the deterioration is improving, and markets are giving the current government the benefit of the doubt, driving a compression in credit premiums (5yr CDS have tightened 300bps since their highs a couple of years ago, trading around 200bps at the moment).

CONTACTS

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

Chart 1

Sources: Scotiabank Economics, BCB.

Chart 2

Sources: Scotiabank Economics, IBGE.

Regarding monetary policy, the DI curve shows markets look for 125bps of additional rate cuts. Our take is that although neutral rates have likely fallen somewhat with the changes that the government has implemented and those that are expected (including TJLP reform), they are still relatively high. We would not be surprised if real neutral monetary policy rates are still somewhere around 4%, from around 5% prior to reforms. This means that the additional rate cuts that markets expect from here could be reversed as the economy comes back on track but, for now, we tend to agree that more cuts are likely in the pipeline. However, this view is not without risks. The biggest risk in our opinion is the BRL. Our take is that the real's nominal depreciation has more than been eaten away by inflation, and in our view, the real is now on the "expensive side" (hence our FX call). If the reforms, particularly pensions (for which debate keeps getting pushed back) fall through, we should see market disappointment translate into depreciating pressures on the BRL, which could in turn derail the BCB's easing cycle as Brazil's FX-inflation pass-through is relatively high. Hence, what happens on both the reform and election front next year is key for Brazilian assets, and also for how low local rates can get, and how long they can stay there.

On the political front, there are two major risks worth tracking, and they are both related — and highly relevant to the macro outlook. The first is the reform approval process which is moving forward much more slowly than markets anticipated, and we think it's partly due to the PT now being back on its feet, after seemingly being brought to its knees by President Rousseff's impeachment. A risk is that with Presidential elections looming in November 2018, and the pension reform (arguably the most important) having about a 70% rejection rate, politicians will be unable to get the bill approved before it trips up with the electoral period. The bill has already been materially watered down, but even in its watered-down state, the vote has been repeatedly delayed. Failure to get the bill approved before the end of 18-Q1 would likely trigger some pressure on Brazilian assets. A second risk related to this is how the approval of the pension bill would impact the outlook for next year's elections if it were to materialize. Our take is that markets would see a return of the PT as negative for Brazilian assets, given the poor fiscal performance of the country during its last administration. At the moment, given the judicial process against him, it's unclear whether President Lula will be a contender next year. However, even if he does contend, the path to victory does not look easy despite Lula being the most popular politician in the country. Despite Lula's high popularity (he continues to come out at the top of nearly all polls), he also has a high rejection rate (between 40% and 50% in recent polls), which means winning in a second round run-off would likely be tough, as he has a very low ceiling which should hurt him in a run-off vote. Where the pension bill comes in, is that if approved, it could increase rejection towards reformist candidates, and could tip the electoral balance in favor of the PT, or Lula. Hence, there is both a lot at stake on the political front, but there is also a lot of uncertainty.

Colombia

- **Colombia's economic performance continues to suggest a gradual recovery, consistent with looser policy settings, and a strengthening in confidence, as well as acceleration in the execution of government infrastructure spending which we expect to gain traction over coming months.**
- **Even though we tend to agree with consensus that BanRep will continue to cut rates, we see risks to this view, primarily coming from possible depreciation pressure on the Colombian peso. These pressures could come from worse-than-expected fiscal results, or the upcoming Presidential elections.**

News on Colombia's outlook has been mixed, but remains consistent with an economy that is gradually gaining traction, accelerating as we near year-end. The sectors of the economy that are still serving as a drag are the mining industry and construction. On the construction front, we expect more dynamic performance heading into 2018. Furthermore, it is worth noting that retail sales are posting better performance as the year turns into the second half (+3.0% in the latest release), but they are still being hurt by relatively high unemployment. Hence, we expect GDP to continue strengthening over coming quarters, and sector performance to become more balanced. We expect growth of +1.9% this year (Bloomberg consensus +1.7%), to be followed by a more robust +2.5% in 2018 (Bloomberg consensus +2.6%), and a closer to potential +3.1% in 2019 (Bloomberg consensus +3.0%). The gradual strengthening of the economy is consistent with our view that both the 4G infra program, and the peace process will bring accelerated growth with them, but the benefits will slowly gain momentum.

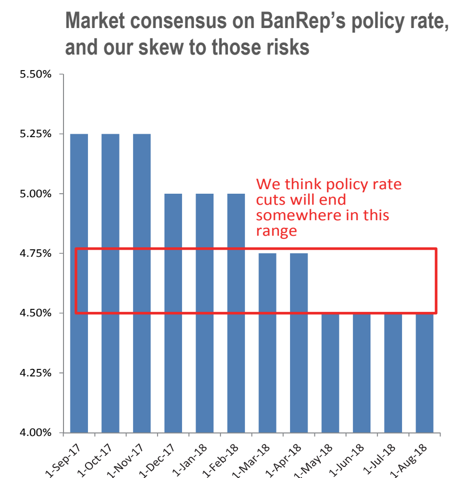
The main concern among market players in our view is whether the rebound will be strong enough to match the macro assumptions that the government is using for its fiscal plan. Markets, and Scotiabank Economics, are still skeptical that the economy can recover enough to match the official projections (we're not sure that growth will top 4.0% in 2019–2025 as the government projects) which feed into the country's fiscal rule. This concern about whether the public finances have been properly anchored is one of the reasons why local rates have come under pressure (upwards), and one of the reasons the country's credit ratings still have some downgrade risk (we assign a 30% probability to a downgrade).

On the rates front, the latest minutes from BanRep are consistent with continued cuts in interest rates, given the board sees inflation still converging towards the mid-point of the inflation target, even if there is some upward pressure from food prices that will generate some noise heading into year-end (similar to elsewhere in LATAM). The latest decision was split, with 4 members voting for a 25bps cut, and 2 members voting for a 50bps cut. There was also one member who voted for a pause. Our take is that acceleration in the pace of rate cuts is unlikely, given the majority of the board believes that—with the cut delivered last time—rate settings are already in neutral. The board believes the economy has

CONTACTS

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

Chart 1



Sources: Scotiabank Economics, BanRep.

already touched bottom and is starting a gradual rebound—hence we see no rush on the easing front, particularly as food continues to pressure inflation upwards.

Regarding the outlook for interest rates, we are roughly in line with consensus in the latest BanRep survey, although we are relatively hawkish in our skew of risks. The first reason for caution we see is that in the most recent survey of expectations, we saw that economists broadly expect inflation to rise to slightly above BanRep's target as we head to year-end (consensus looks for 4.2% inflation by December). Given the inflation spike is driven by likely temporary pressures coming from food prices, we don't see this shock on its own as serious. However, if the shock were to be accompanied by a material depreciation of the Colombian peso, the risks become higher, given Colombia still has relatively high FX-inflation pass-through (20%–30%).

What can trigger a sell-off in the Colombian peso? Barring an external shock (the Fed?), we believe there are two primary sources of domestic risk: the first is the Presidential elections in May 2018, which could make investors nervous if an anti-establishment candidate were to emerge as a strong contender. Our take is that there will be two main camps within the establishment, primarily representing supporters of President Santos and of former President Uribe. The main difference between the two is approaches to the peace process, and we see little differences on the macro front. However, there is also the possibility that a third camp, to the left of the political spectrum, could emerge (former Mayor of Bogota Gustavo Petro has been strong in recent polls, and we have heard some, still small, degree of concern among investors). The second domestic risk we see is related to public finances, and the potential for credit rating downgrades. If the situation does not improve, we could see downgrades materialize, which would leave Colombia at the threshold of investment grade, which could spook some investors. However, we note we see a loss of investment grade as a low probability risk.

Peru

CONGRESS WINS AGAIN

- **A new cabinet, the same economic policy.**
- **Politics continues to dominate in Peru, even as the economy shows signs of rebounding from the El Niño downturn.**
- **Government reconstruction spending starts to kick in.**
- **High metal prices improve macro accounts.**

Congress, not content with taking down cabinet members one by one, decided to do away with the whole lot by way of a political "censura" on September 15. The head of the cabinet (here popularly called Prime Minister), Fernando Zavala, has been replaced by the current Vice-President and member of Congress, Mercedes Aráoz. Zavala was also Minister of Finance, and has been replaced in that role by Claudia Cooper, who was acting as Vice-Minister of Economy. Other cabinet changes include: Minister of Justice, of Education, of Health, and of Housing. Six cabinet members in all were changed, while twelve were ratified. We do not expect any major disruption in policy, outside of moderate adjustments. The six new members may signify policy shifts within their jurisdictions; however, these shifts will remain within a generally market-friendly and business-friendly framework. This includes Cooper at Finance, who is known to be orthodox and mainstream in her economic views. In general, Peru's new cabinet is similar to the past in that its members are predominantly independent, with a technical (apolitical) profile.

Congress seems to have accepted the new cabinet, at least for now. However, there is no real guarantee that the PPK regime and opposition Congress will get along much better. The replacement of the former Minister of Justice (Marisol Perez Tello), by Enrique Mendoza has reopened the discussion of the pardon ("indulto") and freedom of Alberto Fujimori. An event such as this would have political consequences that are not easy to predict.

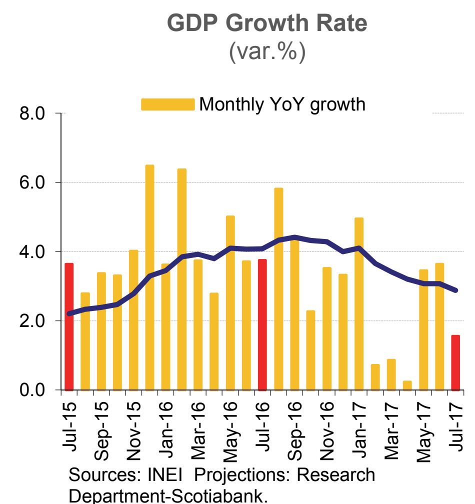
Markets have reacted with calm to the change in cabinet and events that led to it. In part, perhaps, because everything occurred so quickly and over the weekend, but also I believe it reflects the confidence that neither Congress nor the government is interested in changing economic policy significantly.

Meanwhile, economic news is not strong, but in general points to an economy that is rebounding after El Niño. GDP grew 1.6% in July, YoY, and 2.2% during the first seven months of the year. The softer growth figures compared to 3.6% in June and 3.4% in May, reflecting the fact that resource sectors (mining and fishmeal) are no longer driving growth. This was expected. Growth figures from now on will reflect non-resource sectors, more linked to domestic demand, which fell to 1% levels during the El Niño months, and has since rebounded closer to 2%.

CONTACTS

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

Chart 1



Sources: INEI Projections: Research Department-Scotiabank.

The growth outlook is set to improve as we approach the end of the year, as government investment is, finally, rising in earnest and starting to drive the economy. After declining nearly every month from September 2016 to April 2017, government investment has risen at an increasing pace since May, with a 24% YoY increase in August.

Government spending should only get stronger. The government announced details for investment in post-Niño reconstruction and the Panamerican Games, which includes a 10% spending increase in its 2018 budget. Public investment will rise 18%. This is in line with our expectations of GDP growth rising from 2.5% in 2017 to 3.7% in 2018.

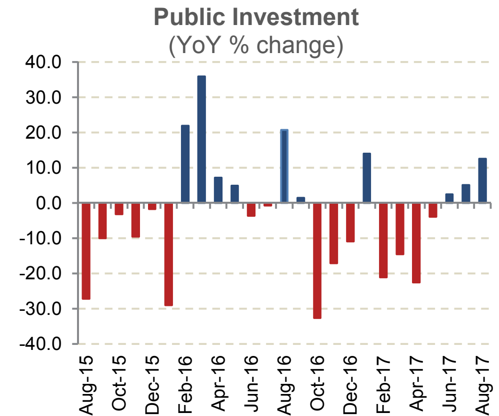
Another source driving growth expectations is the performance of metal prices. Even with the recent retracement, most metal prices that are important to Peru are still way ahead of expectations. This is feeding into improving external accounts, a strengthening FX rate (held back by significant Central Bank intervention), less concern over deteriorating fiscal accounts, and rising business confidence. All in all, macro accounts are improving and expectations are rising, despite political events. This seems largely to be what was behind the decision both by Moody's and Fitch to maintain Peru's credit rating and "stable" outlook.

The Central Bank has continued to do its part as well. The CB lowered its reference rate in September to 3.50%, the third 25bps decline in the year. The CB was clear in signaling that it would reduce the rate in September, and has stated its intention to continue giving clear guidance on what it will do from one month to the next. For October, it has signaled a pause. After that is anyone's guess, but we would not be surprised to see one more 25bps decrease before the CB ends its expansionary policy.

The CB continues to be more concerned about growth than inflation. Twelve-month inflation to August came in at 3.2%. This was above the CB target range, but the CB seems convinced that this reflects temporary supply shocks, and that inflation will fall well below its 3.0% target ceiling before the year ends.

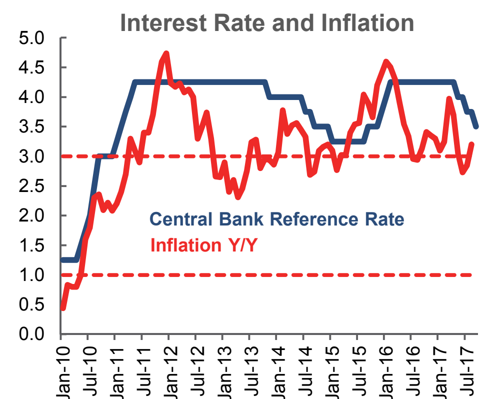
Peru is slowly transitioning to more robust, investment-driven growth. It would be helpful if politics could also transition to a state of less conflict and uncertainty.

Chart 2



Sources: BCR
Elaboration: Research Department-Scotiabank Peru.

Chart 3



Sources: BCR, INEI, EE - Scotiabank.

Chile

RISING OPTIMISM, BUT RISKS REMAIN

- **The situation for the Chilean economy remains very similar to that described one month ago. The economy is stabilizing, and 2018 growth is expected to reach its highest level since 2013 as the political situation improves.**

- **Though risks for 2018 growth are tilted to the upside, worsening terms of trade and some potential political challenges represent possible downside risks to the forecast.**

MACRO UPDATE: SMALL BUT MEANINGFUL CHANGES

No significant data changes have taken place since our last report. We continue to forecast growth of 1.4% for the current year and 2.8% for 2018, which is more conservative than the Central Bank's forecast. In September the Central Bank increased the average of its forecast range for economic growth from 1.375% to 1.5% for the current year and kept the forecast at 3% for 2018. Though the upward revision was modest, it ended the recent string of negative revisions to the growth outlook. On the inflation side, the forecast for the current year was revised down (from 2.6% to 2.4%) and upward for 2018 (3% vs. previous 2.9%). In the same report, the potential growth for the Chilean economy was cut to the range 2.5%–3%.

All in all, although monetary policy rate (MPR) cuts were not ruled out, no change to the MPR (currently at 2.5%) is the most likely scenario for the coming months. Aligned with that, we maintain our expectation of no change in MPR up to mid-2018. Were stronger-than-expected growth to materialize, this could lead to a re-assessment of this view. In the very short term, the Central Bank should not be too uncomfortable with a twelve-month accumulated inflation temporarily in the low half of its reference range (2%–4%). Along with the reduction in inflation, the exchange spot rate (CLP/USD) started to recover, though there was likely a much more powerful reason for it: a pullback of the copper price and the strengthening of the US dollar in the international markets. We continue to expect a year-end value around 640, which would be consistent with forecast values for most of the variables that historically condition the exchange rate.

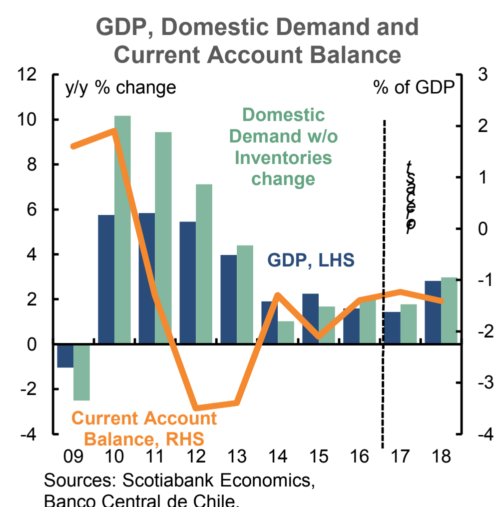
POLITICAL PANORAMA: SHARPER PICTURE… STILL BLURRY

In the political arena, the changes have not been very dramatic either. Surveys show that relative position for presidential election remains almost the same, led by former President Sebastián Piñera (center-right) with 43%, followed far behind by Alejandro Guillier (center-left, pro current Government) with 19%, and Beatriz Sánchez (left) with 13%. Just to Piñera's left and right there are two candidates (Goic and Kast, respectively) with 4% each. That picture means the November 19th election will be followed by a ballotage on December 17th, for which Mr. Piñera keeps the first option. Though this is the most likely scenario, there are two additional political risks: first, the parliamentary election (half senate and whole Deputies Chamber) where results are far from being clear and, second, the ability

CONTACTS

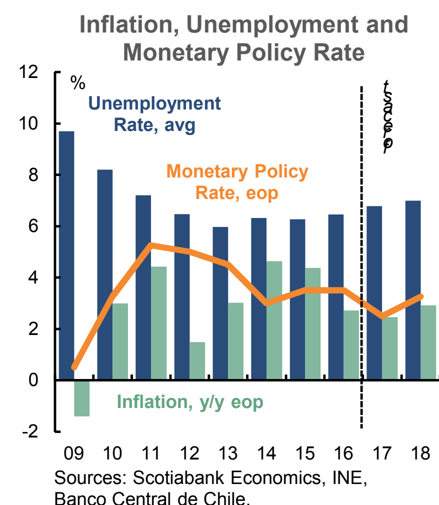
Benjamin Sierra
56.2.2619.4974 (Chile)
Scotiabank Chile
benjamin.sierra@scotiabank.cl

Chart 1



Sources: Scotiabank Economics, Banco Central de Chile.

Chart 2



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

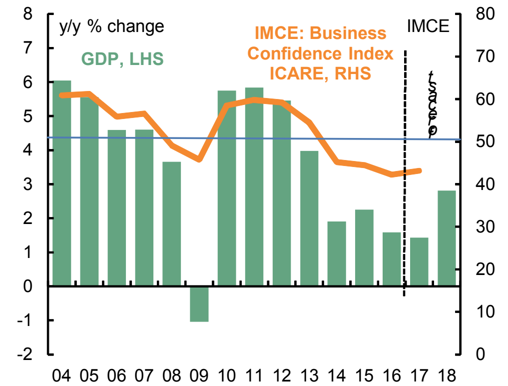
of the new Administration to accomplish both short- and long-term improvements (tax reform, labor reform, environmental institutions, among many other). Some surveys show that this political uncertainty, though lower than in other Latin American countries, in addition to the implementation of damaging reforms in the previous three years and the deterioration of the terms of trade, has reduced the flow of investment, with investors adopting a wait-and-see attitude.

The resignation of the core of the economic team (on August 31st) highlighted the cracks in the ruling coalition, but is unlikely to mean dramatic changes in the current economic policy of the government. Its tenure ends within six months (on March 11th, 2018), which is a limited timespan to make changes, especially when the government's popularity, though improving, is still low and there is a widening rejection of previous reforms or, at least, skepticism about them. The new economic team (which is headed by the same people as in Mr. Lagos' center-left administration in 2000–2006) is apparently focused on continuing with the previous line, to capitalize on improvement in expectations or growth that could come from better terms of trade and the perspective of a new political environment (as in other countries in the region). In that context, the design of a 2018 balanced budget seems the first priority.

MAIN RISKS

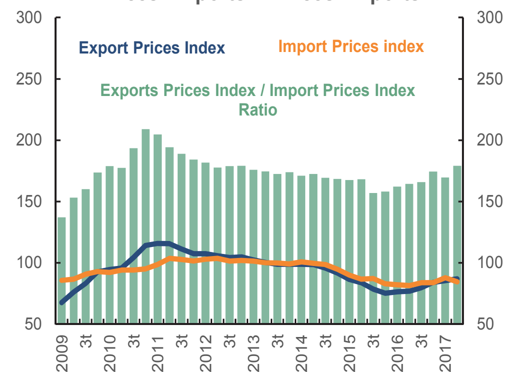
These conditions for investment imply a two-fold short-term risk: a) decisions could be on hold before knowing the result of the election and the performance under the new political scenario, and/or b) a growing pent-up demand for investment that might burst in 2018. Of course, consequences of the first would be more concerning that those of the second, but either of them might cause large impacts in activity, demand, prices, rates, etc.

Chart 3



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

Chart 4



Sources: Scotiabank Economics, Banco Central de Chile.

China

- **China is set to remain among global engines of growth, yet real GDP gains will likely decelerate to 6% y/y by the end of 2019.**
- **Important leadership meeting in October will determine the pace and focus of forthcoming structural reforms.**

ROBUST ECONOMIC GROWTH AHEAD OF PARTY CONGRESS

China's economic growth will remain reasonably sound through 2019 despite the fact that the pace is set to decelerate gradually. We estimate that the nation's real GDP growth will average 6.7% this year and move toward the 6% mark by 2019. The moderate slowdown reflects the economy's continued transition from reliance on credit-fuelled investment toward consumer-driven activity (chart 1) and it will put the Chinese economy onto a healthier and more sustainable footing. Despite the gradual deceleration, China will continue to be among the world's growth outperformers and its significance in the world economy will continue to increase. We assess that while the economy has built substantial imbalances in recent years due to poor allocation of resources—such as credit—the country's economic outlook is favourable enough for the government to meet its goal of doubling China's 2010 GDP and per-capita income by 2020.

China recorded relatively rapid real GDP growth in the first half of this year, with output expanding by 6.9% y/y (chart 2). Accordingly, the economy will comfortably meet the government's official 2017 growth target of at least 6.5%. We expect output gains to be smaller over the coming quarters on the back of the waning base effect of public spending, which was up by 21% y/y in the first half of 2017. The robust growth momentum so far this year has supported social stability and created a favourable economic environment for the 19th National Congress of the Communist Party of China, which will commence on October 18, 2017.

LEADERSHIP CHANGE TO SPUR STRUCTURAL REFORMS

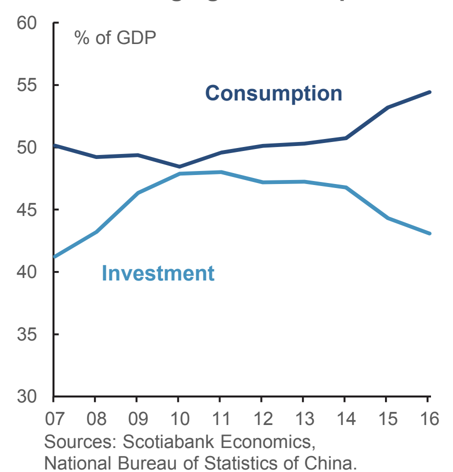
The 19th National Congress, which takes place only twice in a decade, marks the mid-point of President Xi Jinping's 10-year term. The new composition of the Politburo Standing Committee—China's top policymaking body—will be closely watched as up to five out of seven members of the committee are expected to retire this year due to the party's unwritten age limits. The remaining two members are President Xi himself and Premier Li Keqiang. Among the expected retirees is President Xi's close aide Wang Qishan who has been the leader of China's rigorous anti-corruption campaign. The configuration of the new committee will determine how fast China's economic liberalization will progress over the coming years.

We expect to see somewhat faster progress on economic reforms following the party congress. Efforts will likely be focused on strengthening the banking system's resilience—by improving risk management, bolstering the regulatory framework, promoting gradual deleveraging, increasing transparency, and managing the resolution of troubled loans—that is a reform priority before the economy can be liberalized further. It is also likely that policymakers will place

CONTACTS

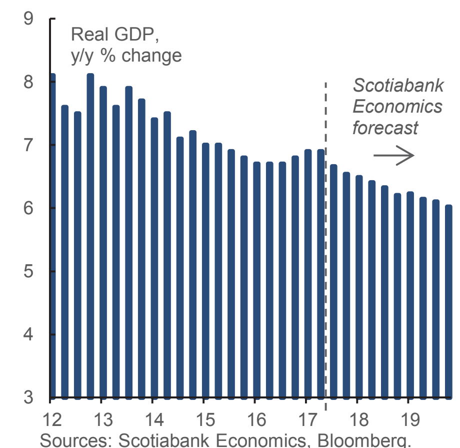
Tuuli McCully
65.6305.8313 (Singapore)
Scotiabank Economics
tuuli.mccully@scotiabank.com

Chart 1



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

Chart 2

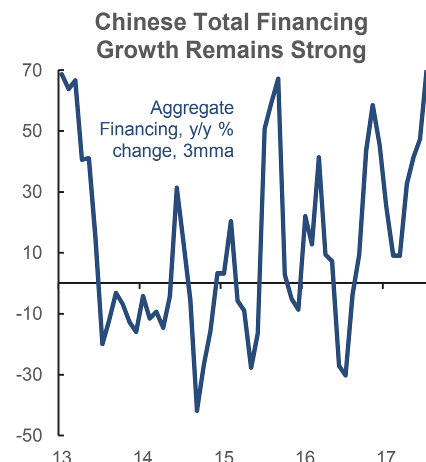


Sources: Scotiabank Economics, Bloomberg.

less emphasis on achieving short-term real GDP growth targets and more on financial stability, given elevated risks stemming from continued rapid credit growth (chart 3) and China's high corporate debt burden. Within the universe of banking system reforms, we believe that increasing the depth of the financial sector is a vital aspect of near-term structural changes as it would promote stronger capital flows into China and lessen pressure on the capital account that is currently curbed by tighter capital controls.

In addition to financial sector reforms, we continue to pay attention to any progress made toward meeting China's long-term goal of having markets play a "decisive role" in resource allocation. A key element of meeting this objective is faster advancement in reforming state-owned enterprises (SOEs), which dominate the economy and tend to be less efficient than their private-sector counterparts. There are around one hundred massive SOE conglomerates in China, yet when their subsidiaries are included the number of nonfinancial companies climbs to 167,000. According to estimates by the International Monetary Fund, the productivity of Chinese SOE's is 25% lower than in corresponding private companies. We expect to see further progress on consolidating SOEs, curtailing their losses, reducing their non-commercial functions, incorporating SOE subsidiaries, and opening some SOE-dominated sectors to private investment.

Chart 3



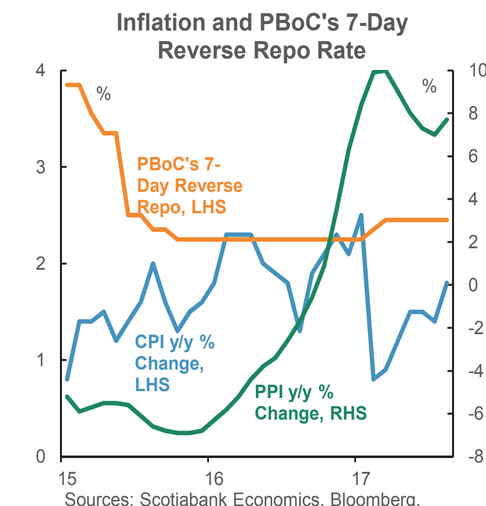
Sources: Scotiabank Economics, Bloomberg, The People's Bank of China.

PRUDENT AND NEUTRAL MONETARY POLICY TO BE MAINTAINED

China's monetary conditions are set to remain "prudent and neutral" over the coming months, according to the People's Bank of China (PBoC). The country's monetary policy has become more market-based in recent years and the central bank is now using the 7-day reverse repo rate as its de-facto policy rate to signal monetary policy intentions (yet officially the one-year loan and deposit rates are still the formal benchmark interest rates and are determined by China's State Council). The 7-day rate has remained at 2.45% since March after it was increased by a total of 20 basis points in the first quarter of 2017. We expect monetary policy to be tightened cautiously in the latter part of the forecast horizon, yet conditions are set to remain relatively loose overall against the backdrop of slowing economic growth momentum.

Price pressures remain well contained in China with headline inflation currently hovering below 2% y/y (chart 4). We expect only gradual strengthening in inflationary pressures over the coming quarters with the inflation rate reaching 2½% y/y by the end of 2019. As part of China's financial market liberalization efforts over the medium-term, the PBoC will likely move away from money growth targets toward inflation-targeting. Such transition will eventually improve monetary policy transparency and credibility, which are important prerequisites for successful internalization of the Chinese renminbi (CNY). In the meantime, we expect Chinese policymakers to increase exchange rate flexibility slightly. This is likely to happen through a wider CNY trading band around the PBoC's reference rate; we believe that the existing ±2% band may be enlarged—potentially to ±3%—soon after the party congress.

Chart 4



Sources: Scotiabank Economics, Bloomberg.

Japan

- **Strong economic activity has yet to feed wage gains and inflation.**
- **Politics dominate the near-term outlook.**

SOLID GROWTH AND LOW INFLATION

Japan's current economic activity is stronger and more broad-based than it has been in years. Real GDP growth averaged 1½% y/y in the first half of the year (chart 1), driven by domestic demand, particularly household consumption and fixed investment. In addition, Japan's external sector is responding to strengthening global demand and international trade, with net exports contributing to real GDP gains. We expect Japan's economic growth to average 1.6% y/y in 2017, well above the nation's potential growth rate of around ½% y/y. We estimate that output gains will be lower—and more sustainable—in 2018–19, averaging 0.9% y/y.

Japan's inflationary pressures remain low. Despite a tight labour market, higher corporate profits and a recent pick-up in business investment, wage increases remain muted (chart 2), questioning the sustainability of Japan's recovery. Until we see solid wage gains, Japan's inflation is set to stay low. In recent months price increases have hovered near ½% y/y. Should Japan's consumption tax rate be hiked from 8% to 10% in October 2019 as currently planned, inflation will break the BoJ's 2% y/y inflation target in the final months of 2019, mimicking the price evolution after April 2014 when the tax rate was raised from 5% to 8% (chart 2). However, excluding this temporary impact, inflation will likely stay below the 2% mark in the foreseeable future. The Bank of Japan (BoJ) is expected to maintain loose monetary policy through our forecast horizon. The short-term policy rate will likely remain at -0.1% and the BoJ will continue to adjust the amount of its bond purchases depending on market developments, aiming to keep the 10-year government bond yield relatively close to 0%. While cautious alterations to the BoJ's asset purchase program are possible before the end of 2019, we do not expect the policy rate to be increased within our forecast horizon.

JAPAN IN ELECTION MODE

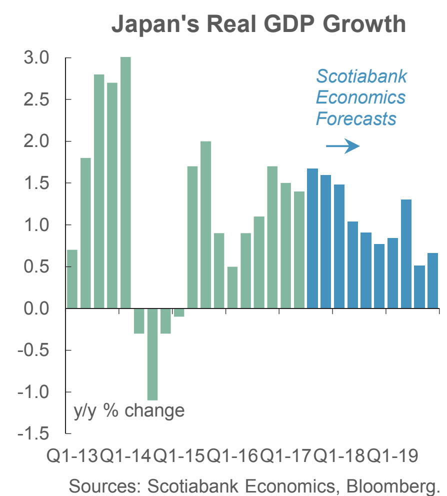
The economy's favourable backdrop prompted Prime Minister Shinzo Abe to call a snap election for October 22. The election for the House of Representatives (the lower house) was to be held by the end of 2018. Prime Minister Abe will be seeking to capitalize on stronger public support for his Liberal Democratic Party (LPD) and disarray in the opposition. Currently, the LPD and its coalition partner Komeito hold a two-thirds majority in the lower house. Renewing the solid mandate would allow the government to focus forcefully on structural reforms.

The run-up to the election will likely be characterized by debates about Japan's North Korea strategy and the revamping of the Japanese social security system against the backdrop of a rapidly aging society. In addition, Prime Minister Abe will be seeking a clear mandate to be able to move ahead with the second consumption tax rate increase in 2019. To gather support for the hike, he has signaled intentions for less fiscal consolidation, promising to direct the tax revenues to areas such as education and care services for the elderly.

CONTACTS

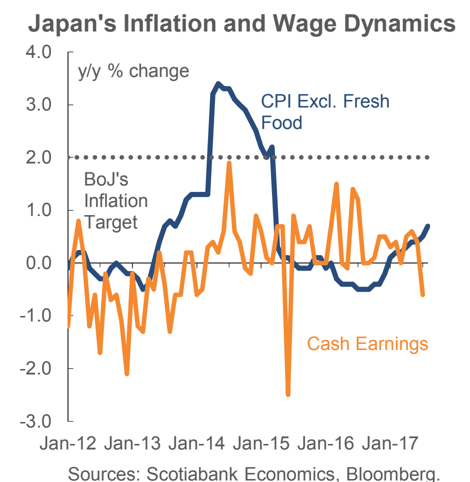
Tuuli McCully
65.6305.8313 (Singapore)
Scotiabank Economics
tuuli.mccully@scotiabank.com

Chart 1



Sources: Scotiabank Economics, Bloomberg.

Chart 2



Sources: Scotiabank Economics, Bloomberg.

India

- **Structural reforms improve India's business environment and promote medium-to long-term growth.**
- **Central bank remains committed to inflation-targeting amid potentially looser fiscal policy stance.**

ECONOMY TO FEEL SHORT-TERM PAIN FOR LONG-TERM GAIN

The Indian economy is going through a soft patch. Second quarter real GDP data disappointed with output increasing by only 5.7% y/y after an already weak reading of 6.1% y/y in the January–March period (chart 1). The deceleration was broad-based including consumer and public spending. Encouragingly, however, fixed investment growth returned to positive territory yet it still remains rather weak. We expect the growth deceleration to be temporary, reflecting disruptive structural reform implementations. India's real GDP growth will likely slow to 6½% y/y in 2017 from the 7.6% pace recorded in 2016.

India's medium-to longer-term outlook is more encouraging. We assess that recent reforms—such as the goods and services tax, bankruptcy code, and various efforts to formalize the economy—will be growth-supportive over the coming quarters as they simplify India's complicated business environment and encourage private sector investment. Additionally, ongoing progress on cleaning up bank balance sheets will improve monetary policy transmission and stimulate lending. We expect India's economic growth to accelerate to 7½% y/y in 2018–19.

POTENTIAL FISCAL BOOST FORBIDS MONETARY POLICY SUPPORT

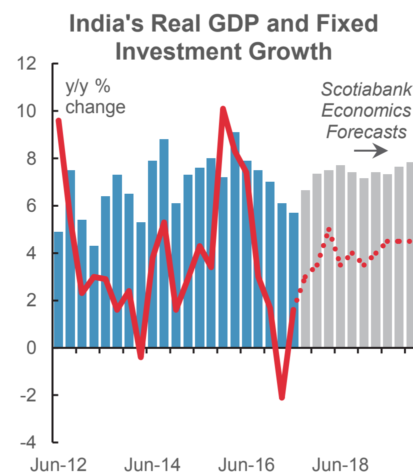
Responding to weak economic growth, the Indian government may consider new fiscal stimulus measures to underpin domestic demand. Speculation regarding a looser fiscal stance has triggered investor concerns about the sustainability of India's fiscal position, which is already one of the economy's weakest links. Until now, the administration had aimed to narrow the central government deficit to 3% of GDP by FY2018–19 (April–May). Any slippage from meeting the target could undermine India's chances of receiving a sovereign credit rating upgrade from Moody's, which currently holds a "positive" outlook on India's "Baa3" rating.

Weak economic growth will likely increase pressure on the Reserve Bank of India (RBI) to ease monetary conditions further; the central bank cut the benchmark repo rate by 25 basis points to 6.0% following the August 1–2 monetary policy meeting on the back of benign inflationary developments (chart 2). Nevertheless, we expect the RBI's monetary policy stance to remain unchanged in the near term given that the government may adopt a looser fiscal stance. On various occasions, the RBI has highlighted that potential fiscal slippage is one of the key risks to the country's inflation outlook. Moreover, further benchmark interest rate reductions would likely have only a minimal impact on stimulating the economy given persistently abundant liquidity in India's banking system. Inflation—at 3.4% y/y in August—has already started to accelerate after reaching its low point of 1.5% y/y in June. We estimate that the headline rate will climb gradually higher through 2019, yet it will stay within the RBI's medium-term target of 4% ±2% y/y. We expect the RBI to start a cautious monetary tightening phase in early 2019.

CONTACTS

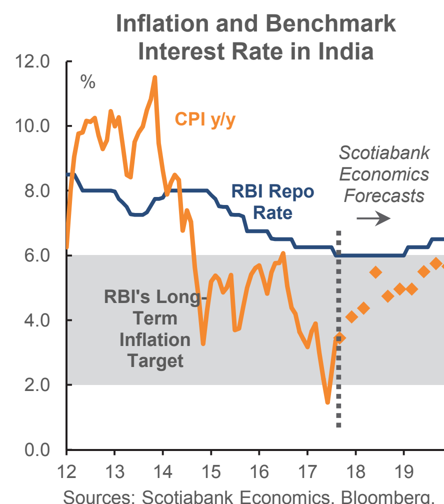
Tuuli McCully
65.6305.8313 (Singapore)
Scotiabank Economics
tuuli.mccully@scotiabank.com

Chart 1



Sources: Scotiabank Economics, Bloomberg.

Chart 2



Sources: Scotiabank Economics, Bloomberg.

Australia

- **Steady as she goes.**

DOMESTIC DEMAND TO DRIVE GROWTH THROUGH 2019

The outlook for Australia's economic growth for 2017–19 is relatively stable with real GDP forecasted to expand in line with the economy's potential growth rate of 2½% y/y. We expect iron ore and coal prices to shift lower over the coming months, which will weaken Australia's terms of trade and export sector activity. Nevertheless, higher export volumes following mining project completions will provide some offset. Against this somewhat uncertain external backdrop, Australia's economic momentum will be reliant on domestic demand. Continued monetary policy support is needed to underpin a sustained—and growth generating—pick-up in non-mining investment given that Australian consumers' spending power is limited by high household debt and still-weak wage gains.

Australia's real GDP gains averaged only 1.8% y/y in the first half of 2017. We estimate that growth in the second half of the year will prove stronger, albeit partially for arithmetical reasons. Given a weak base caused by a contraction in output (in q/q terms) in the third quarter of 2016, Australia's annual economic growth is estimated to average close to 3% in the July–December period, taking the 2017 growth to 2.4%. In 2018–19, we foresee that output gains will average 2.6% y/y.

MONETARY NORMALIZATION IN THE CARDS FOR 2019

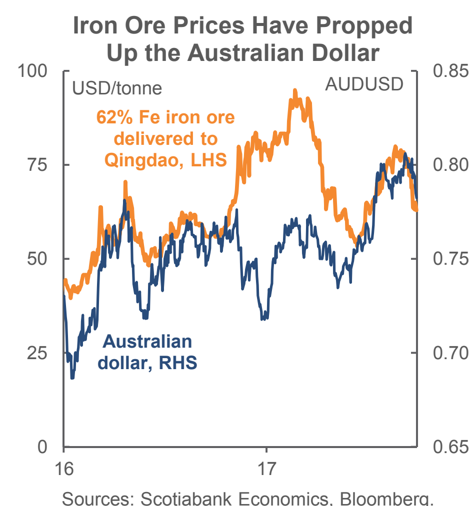
The Reserve Bank of Australia (RBA) will likely maintain accommodative monetary conditions over the coming quarters in order to support domestic demand, leaving the benchmark cash rate at the current level of 1.50%. The RBA's policymakers have recently pointed out that the strength of the Australian dollar (chart 1) is expected to keep inflationary pressures low for the time being and weigh on the outlook for the nation's output and employment. Nevertheless, we do not expect the Australian dollar to appreciate further in the near-term due to lower bulk commodities prices.

The Australian labour market continues to strengthen gradually with full-time jobs driving employment gains this year (chart 2). The labour market will be supported by strengthening non-mining investment growth and the fading adverse impact from declining mining investment. While real wage increases are currently near zero in year-over-year terms, we expect the tightening labour market to eventually translate into modest wage pressures and demand-driven inflation. We estimate that the headline inflation rate will hover near the low end of the RBA's 2–3% inflation target range through 2018 and to climb slowly—but more sustainably—over the course of 2019, reaching 2⅔% y/y by the end of the year. As a response to gradually rising inflation projections, we expect the RBA's first interest rate hike to take place in the fourth quarter of 2018. The RBA will likely have a cautious approach to monetary normalization, with additional adjustments anticipated in the second and fourth quarters of 2019 that take the policy rate to 2.25% by year-end.

CONTACTS

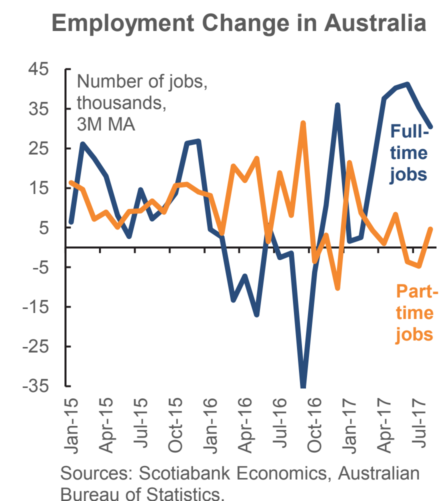
Tuuli McCully
65.6305.8313 (Singapore)
Scotiabank Economics
tuuli.mccully@scotiabank.com

Chart 1



Sources: Scotiabank Economics, Bloomberg.

Chart 2



Sources: Scotiabank Economics, Australian Bureau of Statistics.

Commodities

FOLLOWING DIFFERENT PATHS ON A COMMON UPWARD HILL

- **An accelerating global economy and a weakening US dollar will provide a broadly supportive backdrop and buttress the ongoing recovery of industrial commodity prices.**
- **Oil markets are rebalancing along prior expectations, though bearish sentiment will require further realized supply deficits for WTI prices to break above $55/bbl.**
- **Industrial metals rallied together through Q3, but prices have since diverged and we expect metal-specific fundamentals to drive differentiated price performance through 2019.**

Global commodities are broadly forecast to gain ground through the forecast horizon but recovery paths are increasingly heterogeneous, both across sectors and within them. Energy markets are experiencing gradual, range-bound recoveries against volatile metals performance. While metals rallied together in the third quarter, prices are diverging again as individual fundamentals reassert control. **These market-specific developments are occurring against a widely supportive backdrop, where an accelerating global economy is bolstering commodities demand and broad US dollar weakness is putting upward pressure on dollar-denominated contracts**. Chinese industrial and environmental policy remain the key outlook risks, with the timing of stimulus withdrawal as well as the seriousness of supply-side and environmental efforts likely to keep the market guessing. **On balance, we anticipate that most industrial commodities will continue to gain in year-over-year terms through the forecast horizon, though bulk commodities are expected to undergo a needed correction and precious metals prices are forecast to fall back on a higher rate environment (chart 1).**

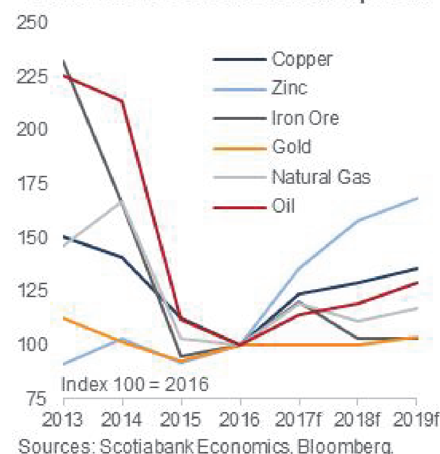
ENERGY: BEARISH OIL SENTIMENT WILL REQUIRE DEEPER, SUSTAINED DEFICITS TO PROVE RECOVERY'S STAYING POWER

The oil market is rebalancing much as expected but prices have lagged the gradual recovery occurring in the physical market, with still-high commercial inventories providing ample cover for bearish sentiment and tilting speculative price movements to the downside. Sentiment headwinds will slow the recovery in crude prices and are the primary reason for **a modest $1–2/bbl decrease to our WTI crude price forecast to average $50/bbl in 2017, $52/bbl in 2018, and $56/bbl in 2019**. However, we continue to see strengthening fundamentals (chart 2) that will tilt medium-term risk to the upside and ultimately drive prices higher through end-decade, with supply deficits expected to reduce the overhang in OECD commercial inventories back to 5-year average levels by mid-2019. Our optimism is rooted in a less sanguine outlook for US production growth coupled with steady OPEC discipline and weak output through the rest of the world. Demand is expected to continue growing at an above-trend pace of roughly 1.5 MMbpd y/y through 2019 given accelerating global growth and persistently low prices.

CONTACTS

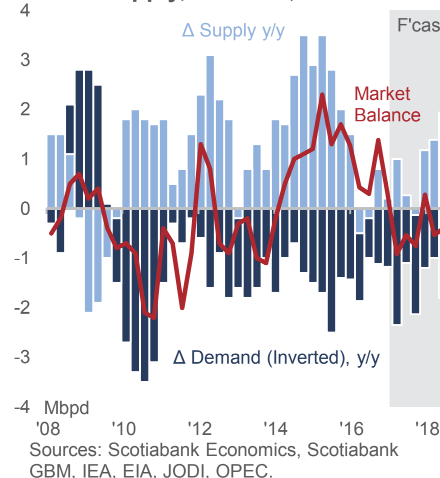
Rory Johnston
416.862.3908
Scotiabank Economics
rory.johnston@scotiabank.com

Chart 1



Sources: Scotiabank Economics, Bloomberg.

Chart 2



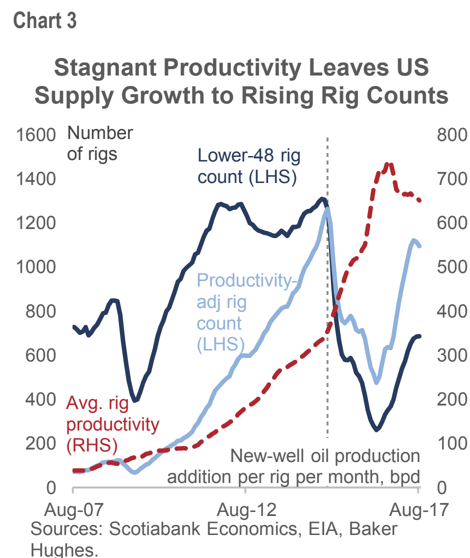
Sources: Scotiabank Economics, Scotiabank GBM, IEA, EIA, JODI, OPEC.

The oil market's intrigue is concentrated on the supply side of the ledger, where growth is expected to slow significantly in 2017 before bouncing back in 2018 as OPEC's return to the market adds to US shale gains. We believe that while US production growth will be impressive by almost every historical standard, shale oil supply will not maintain the 1 MMbpd+ pace of growth witnessed over the past few months but will grow by a still-impressive 500–800 kbpd per year through 2019 given a sub-$60/bbl price environment. Rig counts have plateaued and the efficiency of oil-directed drilling has declined slightly this year with prices stuck below $50/bbl (chart 3), but we expect higher drilling levels to support moderate US production growth as prices drift higher toward $55/bbl. This more gradual pace of US output growth is complemented by a return of OPEC supply in the latter half of 2018 or potentially into 2019, depending on prevailing market conditions. OPEC is expected to manage the return of withheld barrels so as to not undo the progress made by the cartel and its allies since last November. We believe that OPEC will target a production level low enough to keep the market in a modest deficit, whittling away the overhang of OECD industry inventories (chart 4), but not so low as to shock prices too high too fast, pushing the US shale patch into a renewed fervor.

Global petroleum demand growth through 2019 is forecast to average 1.5 MMbpd annually after a strong performance this year on the back of an accelerating global economy and stubbornly low prices (chart 5). Chinese and Indian growth will contribute more than 40% of these gains as emerging Asia continues to offset the stagnant-to-declining demand prospects in OECD countries. Chinese consumption growth is increasingly driven by the demand for consumer-related fuels like gasoline, jet fuel, and propane for cooking, a stark reversal from the norm even a few years ago when growth came on the back of diesel in the industrial sector. India is also a consumer fuel driven story, with gasoline and liquified petroleum gas demand over the past year up more than 10%. While global fuels demand remains strong, we have seen WTI begin trading at a steeper discount to global Brent given the effects of a tumultuous hurricane season on North American crude demand. Refinery outages, primarily stemming from Hurricane Harvey's deluge, have flipped WTI's forward curve into steep contango, depressing prompt prices and indicating a surplus of supply to depressed demand. However, this regional weakness must be balanced against a much tighter market globally, and Brent's forward curve—which is a better reflection of the global trade—has become increasingly backwardated, prompting further stock draws to cover immediate needs.

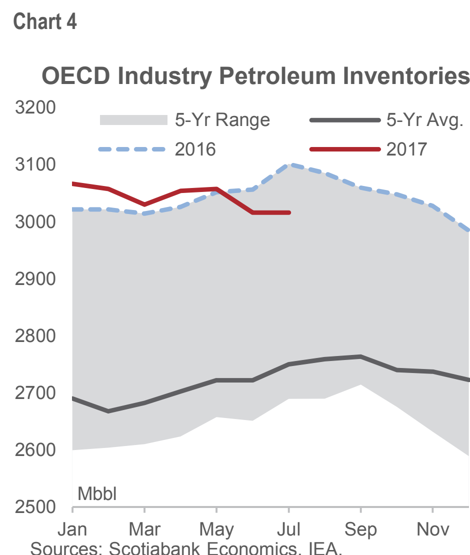
North American natural gas markets are nearer their anticipated long-term balancing level than oil, but prices will be weighed down through 2018 by the delay of expected natural gas power plant start-ups. US natural gas production growth forecasts remain strong on the back of a firmer gas price environment as well as the increased gas supply associated with oil drilling, which is also surging relative to last year. The build-out of natural gas-fed power plants was supposed to absorb a good deal of this new incremental gas output but the delay of these areas of demand will lead to higher inventory levels exiting 2017 than previously expected. **These higher inventory expectations have led us to slightly downgrade our Henry Hub natural gas forecast to average $3.06/MMBtu in 2017, $2.85 in 2018, and $3.00 in 2019**.

Chart 3



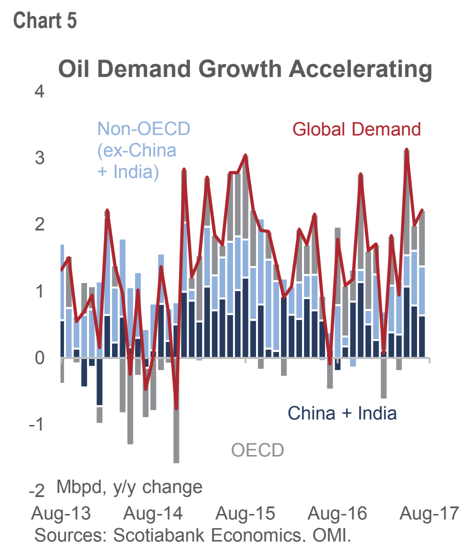
Sources: Scotiabank Economics, EIA, Baker Hughes.

Chart 4



Sources: Scotiabank Economics, IEA.

Chart 5



Sources: Scotiabank Economics, OMI.

BASE METALS: DIVERGENT OUTLOOKS FOLLOWING COLLECTIVE Q3 RALLY

Base metals markets experienced a collective third quarter rally, though prices have since diverged (chart 6) and metal-specific fundamentals are expected to drive individual performance through the forecast horizon.

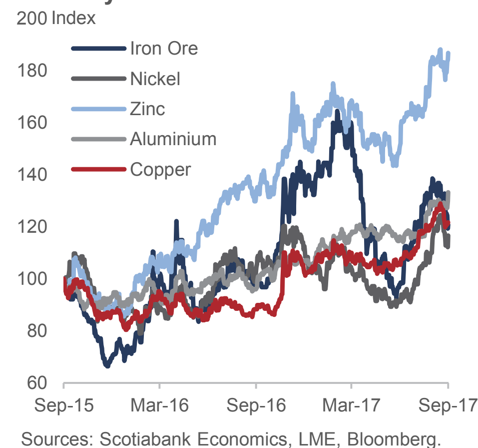
Copper's recent volatility is surprising given a relatively balanced physical market compared with the supply situations in its sister base metals. Moderate surpluses over the past few years have weighed on copper but the recent uptick in Chinese industrial activity pushed "Dr. Copper"—so-called for the belief that the metal's price reflects global industrial trends—into overdrive, leaping from lows near $2/lb last year to recent highs above $3.15/lb. Copper's fundamentals have tightened modestly since our last outlook but not nearly enough to justify recent price gains, and promising drawdowns of copper inventories proved to be a false start after fresh deliveries to LME sheds have left exchanges well-stocked (chart 7). **The completion of new mines as well the expansion of legacy mines, primarily in Chile, Zambia, and the DRC will tilt the market back to small surpluses over the forecast horizon, but an emptying of that mine capacity pipeline is expected to push prices to average $2.85/lb in 2018 and $3.00/lb in 2019**.

The nickel market is experiencing growing supply deficits, but price performance is inhibited by a significant inventory overhang stemming from a decade of oversupply. A gradual reduction of these inventories is forecast to put soft upward pressure on nickel prices, which are expected to average $4.65/lb in 2017, $5.00/lb in 2018, and $5.50/lb in 2019. Our outlook assumes that mines shuttered under Philippine environmental audits are restarted, but slow progress on that front tips our forecast risk to the upside, with less Philippine supply leading to more aggressive stock drawdowns and thus a steeper upward price path.

Zinc continues to enjoy the strongest fundamentals within the base metals complex and supply tightness is expected to push prices higher than today's already-inflated levels, averaging $1.50/lb in 2018 and peaking at $1.60/lb in 2019. Initially, these high prices had released a new wave of supply—primarily from Chinese mines—and had spooked the market but those supply gains have evaporated (chart 8), putting zinc back on our assumed path toward acute tightness over the next two years. However, we anticipate that prices in the $1.50–1.60/lb range will be sufficient to incentivize new mine supply onto the market and prices are expected to gradually come back down from 2019 onward. This downtrend from cycle highs will be amplified by the likely demand destruction that will occur as manufacturers shift to other, less zinc-intensive galvanizing processes. Future supply gains are expected to come largely from China and Australia, with additional new mine supply expected from South Africa, India, Peru, and Mexico.

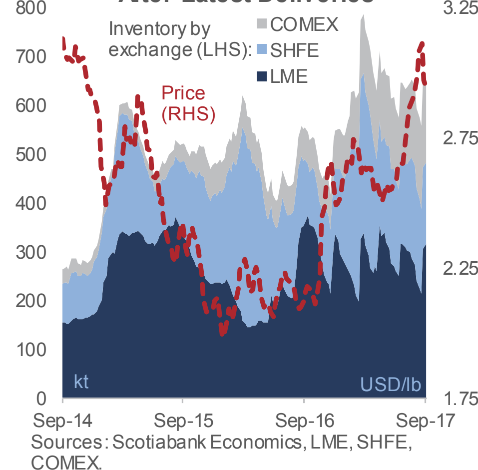
The aluminium market remains on edge as participants await the onset of the much-telegraphed winter capacity cutbacks which, when combined with recent government moves to shutter inefficient smelting capacity, have pushed prices to five-year highs near $1/lb as fears of supply shortage incentivize prompt buying. However, the aluminium market appears fundamentally balanced absent significant and sustained policy action out of Beijing, and ultimate price levels will be determined by how much capacity is affected in China, for how long, and what prices are needed by ex-Chinese smelters to profitably restart idled plants. **We expect aluminium prices to average $0.90/lb through 2019, but risks are on the upside given the potential for deeper, longer environmental policy action in China**.

Chart 6



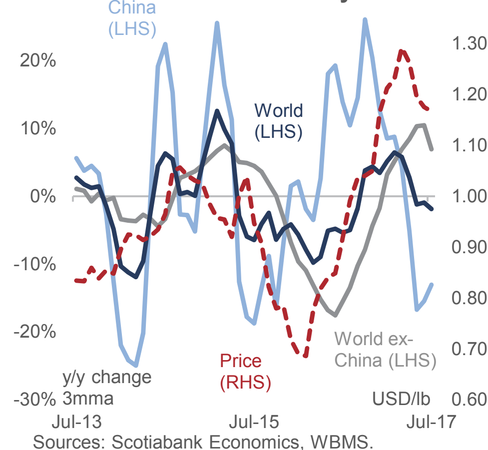
Sources: Scotiabank Economics, LME, Bloomberg.

Chart 7



Sources: Scotiabank Economics, LME, SHFE, COMEX.

Chart 8



Sources: Scotiabank Economics, WBMS.

BULK COMMODITIES: ENJOY THESE PRICES WHILE THEY LAST

Bulk commodities like iron ore and coking coal have continued to surprise on the upside after receiving a demand jolt from newly profitable Chinese steel mills (chart 9), which increased imports of raw materials and strained seaborne supply. Stimulus has kept steel demand high at the same time that the government has been closing inefficient "illegal" smelting capacity, reducing domestic supply. This current market tightness is further exacerbated by China's looming winter capacity cutbacks, which have prompted affected mills to increase production today in hopes of offsetting forced idling between October and March; this intertemporal demand shifting has benefitted bulk commodities recently but will weigh on prices through the winter months as steel production and thus the need for imported feedstock falls away. **Iron ore prices are expected to average $60/t through the forecast period**, the upper end of the seaborne cost curve and more than sufficient to bring enough ore to market given a less compressed demand schedule. Hard coking coal (HCC) prices are expected to see a similar downtrend toward marginal pricing following this past year's roller coaster, which saw HCC gyrate between $150 and $310 per tonne on an assortment of supply-side constraints. **HCC prices are expected to fall to $150/t in 2018 and $130/t in 2019 barring further weather-related supply tightness**.

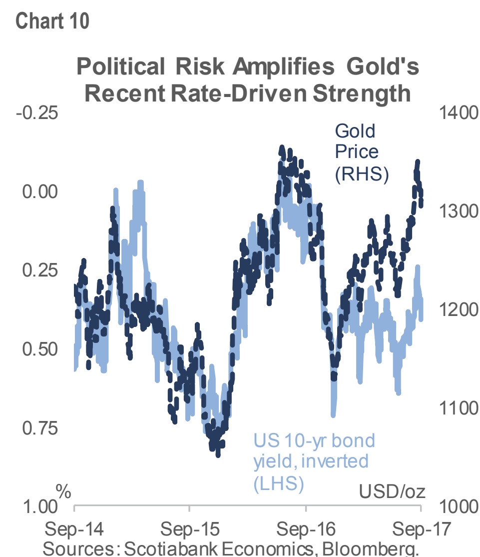
Chart 9

Sources: Scotiabank Economics, Bloomberg.

PRECIOUS METALS: GOLD RANGEBOUND ON WEAK DOLLAR, HIGHER RATES

The price of gold remains elevated after briefly breaching $1,350/oz in September, its highest level of the year, on falling market expectations of interest rate hikes in the US, a weakening US dollar, and heightened geopolitical risk concerns related to mounting rhetorical volleys between Washington and Pyongyang (chart 10). Despite these bullish gold factors, we believe that the market is currently underpricing the likelihood of further tightening by the US Federal Reserve later this year. We forecast that the US Fed will hike in December and as such gold will face dual headwinds, with gold expected to weaken on a higher real rate path as well as a temporarily stronger US dollar. **Following this adjustment, we believe that gold will average $1,300/oz in 2018 and 2019**. Anticipated continued US dollar weakness after a brief fourth quarter rebound is expected to provide gold with upward support and mitigate the downside pressure from a rising rate environment globally.

Chart 10



Sources: Scotiabank Economics, Bloomberg.

Table 1

Commodities	2000–2016			Annual Average			
	Low	Avg.	High	2016	2017f	2018f	2019f
WTI Oil (USD/bbl)	17	63	145	43	50	52	56
Brent Oil (USD/bbl)	18	66	146	45	51	53	57
Nymex Natural Gas (USD/mmbtu)	1.64	4.94	15.38	2.55	3.08	2.85	3.00
Copper (USD/lb)	0.60	2.35	4.60	2.21	2.72	2.85	3.00
Zinc (USD/lb)	0.33	0.81	2.10	0.95	1.29	1.50	1.60
Nickel (USD/lb)	2.00	7.26	24.58	4.36	4.65	5.00	5.50
Aluminium (USD/lb)	0.56	0.86	1.49	0.73	0.87	0.90	0.90
Iron Ore (USD/tonne)	17	67	187	58	70	60	60
Metallurgical Coal (USD/tonne)	39	127	330	114	206	150	130
Gold, London PM Fix (USD/oz)	256	869	1,895	1,251	1,265	1,300	1,300

Sources: Scotiabank Economics, Bloomberg.

Foreign Exchange

US DOLLAR TRENDING LOWER

We retain a generally negative view of the outlook for the **US dollar (USD).** The USD has weakened broadly against the major currencies over the past three months and has tended to lose ground against many Asian and Latin American currencies over the same period. Persistent market doubts about the Federal Reserve's ability to tighten monetary policy amid weak growth in measured inflation at the consumer level have undercut support for the USD. We expect a modest tightening in Federal Reserve (Fed) monetary policy in December to help arrest the USD slide through year end but the broader and longer-run outlook for the dollar is tilted firmly to the downside.

The Fed will continue to tighten monetary policy gradually in 2018 but we do not necessarily think the USD will benefit. Strongly USD-positive nominal short-term rate spreads failed to prevent the USD from falling this year against the likes of the euro (EUR), pound (GBP) and even the yen (JPY). Additionally, improving growth trends in the global economy means less compelling growth differentials to support the USD over the medium term. And finally, while the Fed is well on the way to policy normalization, other central banks—especially the European Central Bank (ECB) and the Bank of England (BoE)—are only just nearing the start of their adjustment process. The USD's experience suggests that markets will move to discount the end of extra-ordinary monetary policy in other currencies aggressively and ahead of time.

From a broader perspective, we remain of the view that the longer-term trend in the USD has rolled over and reversed; secular bull and bear trends in the USD have lasted around eight years on average since the 1970s, suggesting that, with the 2008/2017 bull phase maturing, longer-term trend risks are tilted to the downside for the USD from here.

We remain constructive on the outlook for the **Canadian dollar (CAD)** through 2018. An earlier and more aggressive start to the Bank of Canada's (BoC) tightening cycle had driven a rapid appreciation in the currency since the middle of the year but gains may now slow or even reverse modestly into year end. From a seasonal point of view, the USD typically strengthens modestly in Q4 and early in Q1 before falling sharply. We anticipate one more rate increase this year and additional BoC tightening in 2018 as the economy improves, providing a key source of support for the CAD during a period of what we expect to be generally stable oil prices. Our forecast implies, however, that the CAD rally will stall late in 2018 and reverse somewhat in the following year as currency appreciation may start to affect the external economy's performance.

The EUR will continue to appreciate through our forecast timeframe. We do expect the rapid appreciation in the single currency in the past few months to moderate or unwind somewhat into year end. Nevertheless, even at this stage, we view 2017 as being a very positive year for the EUR with strong price gains overall thus far strongly suggesting that the EUR's secular trend decline from its 2008 peak around 1.60 halted this year at 1.03 and will reverse moving forward.

CONTACTS

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

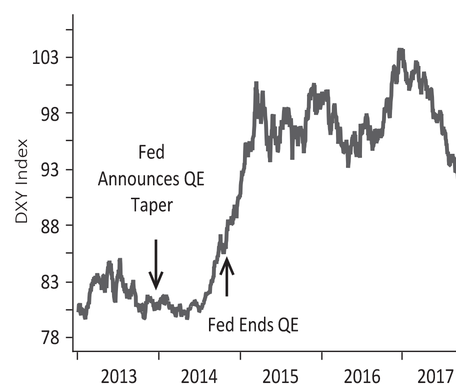
Eduardo Suárez, VP, Latin America Economics
52.55.9179.5174 (Mexico)
Scotiabank Economics
eduardo.suarez@scotiabank.com

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

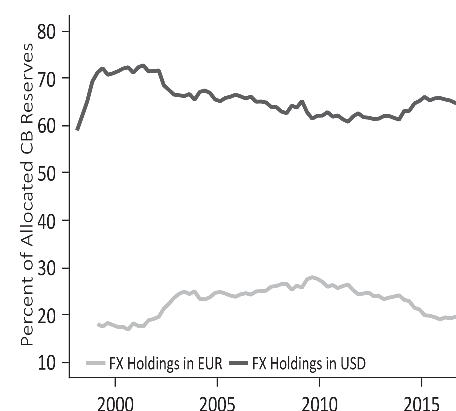
USD on the Rise Well Ahead of QE End



Sources: Macrobond, Scotiabank FICC Strategy.

Chart 2

Central Banks are Underweight EUR



Sources: Macrobond, Scotiabank FICC Strategy.

Eurozone growth momentum remains strong, which will limit near-term EUR weakness, but political risks remain obvious and a potential restraint on gains into mid-2018 (regional independence issues, Italy's general election has to be held by May of 2018). The ECB is edging closer to the end of its asset purchase programme, however, and we expect the eventual normalization of monetary policy to allow investors to refocus on one of the EUR's key structural supports—its large current account surplus relative to the US. We also note that global central banks retain a low relative and absolute exposure to the EUR in reserve asset holdings and large, institutional investors may have to adjust exposure to the EUR as growth strengthens and the ECB exits from extra-ordinary policy accommodation. We look for modest strength in the EUR next year and more obvious gains into 2019 as a result.

Our **GBP** forecast has been upgraded to reflect our call for the BoE to tighten monetary policy later this year in response to high domestic inflation. We expect only a slow tightening in policy, however, with a second hike unlikely before mid-2018—we think May. But considering that few major central banks are even close to raising benchmark rates, even a slight increase in the benchmark rate will help lift the GBP broadly. Brexit remains a risk in the GBP's background but, assuming no significant changes on the domestic political front, we also think a lot of bad news has already been factored in to the GBP at current levels and we rather view the GBP as looking quite cheap still from a longer-term valuation perspective.

The **JPY** will underperform broadly in the coming year. Domestic growth trends remain weak and the BoJ remains far from achieving its 2% inflation goal. This means policy accommodation remaining in place for an extended period as other central banks prepare to exit extra-ordinary accommodation or nudge policy tighter. Relatively weaker growth and accommodative monetary policy settings will weigh on the JPY. We expect the USD to trade up to the 120 area through late-2019 but longer-term charts suggest a risk of more rapid USD appreciation in the medium term if the USD pushes through the 115 area on a sustained basis in the next couple of quarters.

It may still be a bit premature to start worrying about the impact of **LATAM** elections on FX, outside of **Chile**, which is holding its elections in November. Most polls and analysts believe that former President Piñera is likely going to win the election, although there is also uncertainty about whether he will be able to secure a large enough legislative coalition to push forward his agenda, which investors seem to like. Accordingly, over the coming weeks, we expect the Chilean peso will react to polls and what they suggest about the legislative composition. In **Colombia**, fiscal concerns are one of the drivers of recent softness not only in the Colombian peso (COP), but also domestic rates, meaning comments from rating agencies and fiscal and growth numbers should be the major drivers of the COP's price action. Our take is that COP is now somewhat "cheap" from a fundamental perspective (about 5%–10%), but volatility is likely from both fiscal/growth considerations (short term), as well as electoral campaigns (starting early 2018). On the electoral front, we expect both Uribe & Santos aligned candidates to be seen as positive by markets (macro policy continuity). In **Mexico**, the three factors that should determine price action are likely to be: inflation and monetary policy, NAFTA negotiations, and the 2018 elections. We expect NAFTA and monetary policy to be the key drivers in the near term, while elections should kick in as a major driver early in 2018. However, there are still some aspects of the elections that markets need to be mindful off right now, namely who the main parties select as their candidates. We expect those candidates to start emerging late October–mid-November. On NAFTA, even though we expect the final outcome will be positive, it should still be a volatility driver as issues of contention emerge. Our take is that the Mexican peso (MXN) remains about 5% undervalued. However, even though it is cheap, we expect uncertainty related to the NAFTA renegotiation and the 2018 elections to keep the peso on its back foot. **Peruvian** markets seem to be increasingly immune to the domestic political drama playing out, with the reaction to President PPK's cabinet shuffle being quite modest. Behind this market stability, is the view that Peru has already undertaken a lot of the key reforms, meaning that as long as we have a functional government, risks are relatively modest.

Asian EM FX will trade in line with risk sentiment over the remainder of the year. External uncertainties including the stance of the ECB, US macro data, the US debt ceiling issue, US tax reforms as well as geopolitical risks are all issues that may affect regional FX into year end.

The **Chinese yuan (CNY)**'s implied volatility has been rising along with the sliding risk reversal since late August. A neutral risk reversal has paved the way for the regulators to increase two-way flexibility in the yuan exchange rate and push for reforms, such as a wider trading band. The China Finance 40 Forum (CF40), a Beijing-based quasi-governmental think tank, said in a report that it is a good time now for China to carry out further FX reforms and the nation should allow the yuan to become more flexible.

Meanwhile, the PBoC is expected to properly manage market expectations ahead of the ruling party's 19th national congress and US President Trump's visit to China scheduled for early November.

We see downside potential for the **Indian rupee (INR)** in the weeks ahead on rising concern over domestic stimulus plans and possible unwinding of long INR carry position. USD/INR is likely to head for the 66.0 mark. In the medium term, the INR will recoup its losses when the market is convinced of the proposed stimulus package's ability to prop up economic growth.

The Korean won **(KRW)** remains susceptible to downward pressure related to the geopolitical situation on the Peninsula. We are closely monitoring the Taiwanese dollar **(TWD)** and expect USD/TWD to rise towards the 30.5 level should stock outflows continue. The Thai baht **(THB)** will trade along with a broader market tone but outperform somewhat given the nation's solid fundamentals. The BoT has committed to intervening intermittently to curb an excessively strong THB—the best performing currency this year in the region.

APPENDIX 1

International	2000–16	2016	2017f	2018f	2019f	2000–16	2016	2017f	2018f	2019f
	Real GDP (annual % change)					Consumer Prices (y/y % change, year-end)				
World (based on purchasing power parity)	3.9	3.2	3.6	3.6	3.5					
Canada	2.1	1.5	3.1	2.0	1.5	1.9	1.4	1.5	2.0	2.1
United States	1.9	1.5	2.2	2.3	1.7	2.2	1.8	1.8	2.2	2.4
Mexico	2.4	2.3	2.4	2.7	3.1	4.4	3.4	6.6	4.3	3.8
United Kingdom	1.8	1.8	1.5	1.2	2.0	2.0	0.7	3.0	1.9	1.9
Euro zone	1.2	1.6	2.3	2.0	1.8	1.7	1.1	1.6	1.5	1.7
Germany	1.3	1.7	2.3	2.6	2.2	1.5	1.7	1.7	1.5	1.9
France	1.3	1.2	1.8	2.0	1.8	1.6	0.6	1.0	1.0	1.4
China	9.4	6.7	6.7	6.4	6.1	2.3	2.1	2.0	2.5	2.6
India	7.0	7.6	6.5	7.4	7.6	6.9	3.4	4.1	5.0	5.7
Japan	0.9	1.0	1.6	1.0	0.8	0.1	0.3	0.6	1.1	2.3
South Korea	4.2	2.8	2.8	2.7	3.0	2.6	1.3	2.0	2.3	2.5
Australia	2.9	2.5	2.4	2.7	2.5	2.8	1.5	2.0	2.1	2.6
Thailand	4.0	3.2	3.3	3.2	3.4	2.0	1.1	0.3	1.5	2.0
Brazil	2.6	-3.6	0.3	2.5	2.7	6.7	6.3	4.0	4.1	4.0
Colombia	4.0	2.0	1.9	2.5	3.1	5.1	5.7	4.2	3.5	3.0
Peru	5.1	4.0	2.5	3.7	4.2	2.8	3.2	2.8	2.8	2.6
Chile	4.1	1.6	1.4	2.8	3.2	3.3	2.7	2.5	2.9	3.0

Commodities	2000–16	2016	2017f	2018f	2019f
	(annual average)				
WTI Oil (USD/bbl)	63	43	50	52	56
Brent Oil (USD/bbl)	66	45	51	53	57
Nymex Natural Gas (USD/mmbtu)	4.94	2.55	3.08	2.85	3.00
Copper (USD/lb)	2.35	2.21	2.72	2.85	3.00
Zinc (USD/lb)	0.81	0.95	1.29	1.50	1.60
Nickel (USD/lb)	7.26	4.36	4.65	5.00	5.50
Aluminium (USD/lb)	0.86	0.73	0.87	0.90	0.90
Iron Ore (USD/tonne)	67	58	70	60	60
Metallurgical Coal (USD/tonne)	127	114	206	150	130
Gold, London PM Fix (USD/oz)	869	1,251	1,265	1,300	1,300

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

APPENDIX 2

North America	2000–16	2016	2017f	2018f	2019f	2000–16	2016	2017f	2018f	2019f
	Canada (annual % change, unless noted)					United States (annual % change, unless noted)				
Real GDP	2.1	1.5	3.1	2.0	1.5	1.9	1.5	2.2	2.3	1.7
Consumer spending	2.9	2.3	3.5	2.0	1.6	2.4	2.7	2.7	2.5	2.1
Residential investment	3.7	3.0	2.7	-1.3	-1.2	-0.4	5.5	1.5	1.5	1.6
Business investment	2.1	-7.8	1.7	3.7	2.7	2.3	-0.6	4.4	3.5	2.3
Government	2.2	1.8	1.9	1.8	0.9	1.0	0.8	0.1	0.7	0.5
Exports	1.3	1.0	3.0	3.8	3.1	3.6	-0.3	3.2	2.7	2.7
Imports	2.8	-0.9	3.9	3.1	2.7	3.4	1.3	3.8	3.3	3.2
Nominal GDP	4.2	2.1	5.6	4.2	3.9	3.9	2.8	3.9	4.0	3.7
GDP deflator	2.1	0.6	2.4	2.2	2.4	2.0	1.3	1.7	1.7	1.9
Consumer price index (CPI)	1.9	1.4	1.5	1.9	2.1	2.2	1.3	2.0	2.1	2.3
CPI ex. food & energy	1.6	1.9	1.6	1.8	1.9	2.0	2.2	1.8	2.0	2.2
Pre-tax corporate profits	3.3	-4.5	22.0	5.0	1.0	5.5	-2.1	4.0	3.4	0.5
Employment	1.3	0.7	1.7	1.0	0.8	0.7	1.8	1.5	1.2	1.1
Unemployment rate (%)	7.1	7.0	6.5	6.3	6.3	6.2	4.9	4.4	4.3	4.2
Current account balance (CAD, USD bn)	-17.0	-67.0	-60.9	-58.2	-52.2	-507	-452	-491	-552	-605
Merchandise trade balance (CAD, USD bn)	25.1	-26.0	-17.1	-17.1	-14.2	-673	-753	-816	-883	-952
Federal budget balance* (FY, CAD, USD bn)	-2.8	-1.0	-17.8	-17.0	-16.0	-532	-585	-650	-660	-700
percent of GDP	-0.2	0.0	-0.9	-0.8	-0.7	-3.7	-3.1	-3.4	-3.3	-3.4
Housing starts (000s, mn)	199	198	212	198	188	1.27	1.18	1.20	1.25	1.30
Motor vehicle sales (000s, mn)	1,657	1,949	2,000	1,980	1,950	15.5	17.5	17.1	17.4	17.3
Industrial production	0.5	-0.3	5.9	2.1	1.0	0.7	-1.2	1.5	1.8	1.0
	Mexico (annual % change)									
Real GDP	2.4	2.3	2.4	2.7	3.1					
Consumer price index (year-end)	4.4	3.4	6.6	4.3	3.8					
Current account balance (USD bn)	-14.8	-27.9	-20.7	-28.1	-27.7					
Merchandise trade balance (USD bn)	-7.2	-13.1	-6.1	-4.2	-5.8					

Sources: Scotiabank Economics, Statistics Canada, CMHC, BEA, BLS, Bloomberg. * Canadian federal forecast for FY18 & FY19 excludes risk adjustment.

Quarterly Forecasts	2017		2018				2019			
Canada	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Real GDP (q/q ann. % change)	2.3	2.2	1.7	1.7	1.6	1.6	1.4	1.4	1.3	1.3
Real GDP (y/y % change)	3.3	3.2	2.7	2.0	1.8	1.6	1.6	1.5	1.4	1.4
Consumer prices (y/y % change)	1.4	1.5	1.6	1.8	2.0	2.0	2.0	2.0	2.1	2.1
CPI ex. food & energy (y/y % change)	1.5	1.5	1.6	1.8	1.9	1.9	1.9	1.9	1.9	1.9
Avg. of new core CPIs (y/y % change)	1.5	1.5	1.6	1.8	1.9	1.9	1.9	1.9	1.9	1.9
United States										
Real GDP (q/q ann. % change)	2.3	2.7	2.2	2.0	2.0	1.8	1.6	1.6	1.6	1.6
Real GDP (y/y % change)	2.1	2.3	2.6	2.3	2.2	2.0	1.9	1.8	1.7	1.6
Consumer prices (y/y % change)	1.8	1.8	1.7	2.1	2.2	2.2	2.2	2.3	2.4	2.4
CPI ex. food & energy (y/y % change)	1.7	1.8	1.8	2.1	2.1	2.2	2.2	2.2	2.3	2.3

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

APPENDIX 3

	2017		2018				2019			
Central Bank Rates	**Q3**	**Q4f**	**Q1f**	**Q2f**	**Q3f**	**Q4f**	**Q1f**	**Q2f**	**Q3f**	**Q4f**
Americas					(%, end of period)					
Bank of Canada	1.00	1.25	1.50	1.50	1.75	1.75	2.00	2.00	2.00	2.00
US Federal Reserve (upper bound)	1.25	1.50	1.50	1.75	1.75	2.00	2.00	2.00	2.25	2.25
Bank of Mexico	7.00	7.25	7.50	7.50	7.50	7.50	7.25	6.75	6.75	6.75
Central Bank of Brazil	8.25	7.75	7.50	7.50	7.50	7.50	7.50	8.00	8.00	8.00
Bank of the Republic of Colombia	5.25	5.00	4.75	4.75	4.75	4.75	4.75	5.00	5.25	5.25
Central Reserve Bank of Peru	3.50	3.50	3.50	3.50	3.50	3.50	3.75	3.75	4.00	4.00
Central Bank of Chile	2.50	2.50	2.50	2.75	3.00	3.25	3.50	3.50	3.75	3.75
Europe										
European Central Bank	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.25	0.25	0.50
Bank of England	0.25	0.50	0.50	0.75	0.75	1.00	1.00	1.25	1.50	1.50
Asia/Oceania										
Reserve Bank of Australia	1.50	1.50	1.50	1.50	1.50	1.75	1.75	2.00	2.00	2.25
Bank of Japan	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10
People's Bank of China	4.35	4.35	4.35	4.35	4.35	4.35	4.60	4.60	4.85	4.85
Reserve Bank of India	6.00	6.00	6.00	6.00	6.00	6.00	6.25	6.25	6.50	6.50
Bank of Korea	1.25	1.25	1.25	1.50	1.50	1.75	1.75	2.00	2.00	2.25
Bank of Thailand	1.50	1.50	1.50	1.75	1.75	2.00	2.00	2.00	2.25	2.25
Currencies and Interest Rates										
Americas					(end of period)					
Canadian Dollar (USDCAD)	1.20	1.20	1.18	1.18	1.15	1.15	1.17	1.17	1.20	1.20
Canadian Dollar (CADUSD)	0.83	0.83	0.85	0.85	0.87	0.87	0.85	0.85	0.83	0.83
Mexican Peso (USDMXN)	18.05	18.70	18.90	18.75	18.81	19.07	19.17	18.99	19.04	19.31
Brazilian Real (USDBRL)	3.00	3.35	3.45	3.55	3.60	3.40	3.45	3.45	3.50	3.50
Colombian Peso (USDCOP)	3,015	3,005	3,100	3,100	3,050	3,000	3,000	3,050	3,100	3,100
Peruvian Nuevo Sol (USDPEN)	3.24	3.22	3.20	3.19	3.17	3.18	3.19	3.15	3.16	3.13
Chilean Peso (USDCLP)	633	641	641	640	639	638	635	632	628	625
Europe										
Euro (EURUSD)	1.18	1.18	1.18	1.18	1.20	1.20	1.24	1.24	1.28	1.28
UK Pound (GBPUSD)	1.28	1.33	1.35	1.35	1.37	1.37	1.38	1.38	1.40	1.40
Asia/Oceania										
Japanese Yen (USDJPY)	110	112	114	114	115	115	118	118	120	120
Australian Dollar (AUDUSD)	0.75	0.79	0.79	0.79	0.80	0.80	0.81	0.81	0.82	0.82
Chinese Yuan (USDCNY)	6.50	6.60	6.55	6.55	6.50	6.50	6.45	6.45	6.40	6.40
Indian Rupee (USDINR)	64.5	66.0	65.5	65.5	65.0	65.0	64.5	64.5	64.0	64.0
South Korean Won (USDKRW)	1,140	1,160	1,140	1,140	1,120	1,120	1,100	1,100	1,080	1,080
Thai Baht (USDTHB)	33.4	33.6	33.4	33.4	33.2	33.2	33.0	33.0	32.8	32.8
Canada (Yields, %)										
3-month T-bill	1.00	1.30	1.55	1.60	1.80	1.85	2.05	2.05	2.05	2.05
2-year Canada	1.52	1.75	1.85	1.90	1.95	2.00	2.05	2.05	2.10	2.10
5-year Canada	1.75	2.00	2.05	2.10	2.15	2.20	2.25	2.25	2.30	2.35
10-year Canada	2.10	2.20	2.25	2.35	2.45	2.60	2.70	2.75	2.80	2.80
30-year Canada	2.48	2.50	2.55	2.60	2.75	2.90	2.95	3.00	3.05	3.10
United States (Yields, %)										
3-month T-bill	1.04	1.30	1.40	1.60	1.70	2.00	2.05	2.05	2.30	2.30
2-year Treasury	1.48	1.55	1.75	1.85	1.95	2.10	2.20	2.30	2.35	2.45
5-year Treasury	1.93	2.00	2.10	2.15	2.20	2.30	2.40	2.50	2.55	2.60
10-year Treasury	2.34	2.30	2.35	2.45	2.60	2.70	2.75	2.80	2.90	3.00
30-year Treasury	2.86	2.80	2.80	2.85	3.00	3.10	3.10	3.15	3.20	3.30

Sources: Scotiabank Economics, Bloomberg.

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

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

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

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

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

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

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

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

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

Fixed Income Strategy (London)

www.gbm.scotiabank.com

© 2016, The Bank of Nova Scotia

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

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

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

Foreign Exchange Strategy

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

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